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ISSUES RELATING TO HIGH-YIELD SECURITIES (JUNK BONDS)

HEARING

BEFORE THE

SUBCOMMITTEE ON
GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON
BANKING, FINANCE AND URBAN AFFAIRS
HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

SEPTEMBER 19, 1985

Serial No. 99–47

Printed for the use of the
Committee on Banking, Finance and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE
54-887 O WASHINGTON : 1986

H241-19

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ISSUES RELATING TO HIGH-YIELD SECURITIES (JUNK BONDS)

THURSDAY, SEPTEMBER 19, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10:05 a.m., in room 2222 of the Rayburn House Office Building, Hon. Carroll Hubbard, Jr. (chairman of the subcommittee) presiding.

Present: Chairman Hubbard, Representatives Gonzalez, Barnard, and Parris.

Chairman HUBBARD. The Subcommittee on General Oversight and Investigations of the House Banking, Finance and Urban Affairs Committee will now come to order.

On behalf of all the members of our subcommittee, I want to welcome you here today to our hearing on high-yield securities, or "junk bonds," as they are sometimes referred to on Wall Street.

High-yield securities are most commonly defined as high-yield bonds that are a commercial loan in the form of a security, the marketability of which gives investors greater liquidity and opportunities for diversification. High-yield securities include all issues which are either not rated by the major bond-rating agencies, or are rated at least one rating below "investment grade," categories generally referred to as at least BBB by Standard & Poor's and Baa by Moody's.

The bond rating and credit agencies give declining ratings to the issues with perceptions that companies are in progressively less strong positions to pay interest and repay principal.

Because of the increased likelihood that the issuer may not meet the bond obligations, issuers pay a higher rate of interest in order to induce or stimulate investment in the bonds. Hence, increased risk dictates higher yields. The interest rate on high-yield bonds, we are told, may run 3 percent to 5 percent higher than the return rate on investment grade bonds.

The junk bond market is rapidly changing from the "fallen angels" of yesteryear. It used to consist mainly of bonds issued by corporations and public utilities, for example, that were considered at one time to be investment grade by the rating agencies before financial difficulties led to their downgrading.

But the dramatic growth in the junk bond market recently has come from bonds issued by young, emerging companies—successful companies, I might add—which include Humana, Inc., of Louisville,

KY, the noted heart transplant hospital which has recently been in the news, also MCI Communications, and People Express, to name just three.

It has also been pointed out that the high-yield securities market can, at any given time, include many large companies which have experienced a downgrading in their credit rating, such as Ford Motor Co., Chrysler, Montgomery Ward, and Martin Marietta, in addition to the above-mentioned smaller emerging growth companies that have insufficient track records to merit investment grade ratings.

The growth of the high-yield bonds market has given rise to enormous controversy. One primary area being increasingly scrutinized involves the role of high-yield financing as a tool to aid corporate raiders in hostile company takeover attempts. The hostile takeover issue has been the subject of numerous congressional hearings, and we are not attempting to gather additional information today on that matter per se.

Rather, as the Oversight Subcommittee of our House Banking Committee, we are charged with the obligation of apprising the administration of the laws and regulations under the jurisdiction of our full committee.

In 1980, our House Banking Committee began steps toward the deregulation of financial markets through the passage of the Depository Institutions Deregulation and Monetary Act of 1980. That measure and further deregulation legislation, the Garn-St Germain Act of 1982, were designed to allow federally insured thrifts more liberty in the marketplace to meet their obligations to provide home mortgages.

Through that deregulation, many financial institutions have seen fit to invest in high-yield bonds in an effort to diversify their portfolios and maximize their profits. Indeed, it has been reported that one California savings and loan, as of December 31, 1984, owned nearly $1 billion of high-yield bonds out of its total assets of $6.38 billion. However, I believe the testimony of our witnesses today will reveal that the magnitude of financial institutional investment in high-yield bonds cannot be accurately characterized by that one savings and loan out in California.

However, the very nature of these bonds coupled with the uncertainty of how issuers may fare in a time of economic downturn are sources of legitimate concern, inasmuch as these bonds may possess a foreseeable likelihood of default, and thus could possibly contribute to the failure of those financial institutions which have invested in them.

In this time of increasing failures of our financial institutions and because of the strain on our Federal deposit insurance systems which result from these failures, our subcommittee, General Oversight and Investigations, is vitally interested in knowing precisely what dangers, if any, exist for financial institutions which choose to invest in these securities.

We want to help protect the financial community as well as the Federal deposit insurance system and the Federal savings and loan insurance funds, by making assurances that financial institutions are not in a position to make highly speculative investments at the

expense of the insurance funds, their depositors and the Nation's taxpayers.

In addition, yes, today we are interested in how credit markets are affected by junk-bond financed merger activity which drains resources from longer-term investment and growth-enhancing activities.

Finally, we want to explore viable options for presently dealing with the uncertainties involved in the investment of financial institutions in high-yield bonds. That is, should a moratorium or further restrictions be placed on the authority of federally insured financial institutions to make these investments?

Again, I want to welcome and thank our witnesses for joining us today to help find the answers to these questions. We look forward to hearing from the following panel:

Julie Williams, Associate General Counsel and Director, Corporate and Securities Division of the Federal Home Loan Bank Board;

G. Chris Andersen, managing director of Drexel Burnham Lambert Inc., of New York;

Richard T. Pratt, chairman of Merrill Lynch Mortgage Capital Inc., of New York, and, as we know, former Chairman of the Federal Home Loan Bank Board; and

Dr. Edward I. Altman, professor of finance and chairman, Masters of Business Administration Program of New York University.

I shall also be entering in the record the September 18, 1985, letter the subcommittee received from the Chairman of the Federal Reserve Board Paul A. Volcker, who, unfortunately, was unable to deliver testimony to us today.

We look forward to receiving our witnesses' testimony, and at this time, I'll call on our distinguished ranking minority member of our subcommittee, the Honorable Stan Parris of Virginia, to give an opening statement.

Mr. PARRIS. Thank you very much, Mr. Chairman. I have just a brief statement for the record.

I want to thank the chairman for scheduling today's hearing on the impact of investments by some savings and loan institutions in high-yielding, low-grade securities or "junk securities"—depending upon your perspective. Also I thank the distinguished panel that we will hear from for their testimony before us today.

The Federal Home Loan Bank Board permits Federal thrifts to invest up to 1 percent of assets in unrated debt securities. These institutions may also invest in corporate debt securities, including high-yield bonds, under the general commercial lending authority set forth in the Garn-St Germain Depository Institutions Act of 1982.

State banks obtain Federal Deposit Insurance, but do not become members of the Federal Reserve System, are permitted by the FDIC to purchase high-yield bonds. The national banks and the State-chartered members of the Federal Reserve System, however, cannot acquire below investment-grade securities for their portfolio.

According to the Bank Board's recent survey, holdings of high-yield bonds and notes by FSLIC-insured institutions currently total approximately $4 billion—92 percent of which is held by State-

chartered institutions. The Bank Board's survey also reveals that subsidiaries of these federally insured thrifts hold approximately $1.2 billion of low-grade bonds.

As one member of this subcommittee and as an individual Member of the Congress, I am not opposed to savings institutions investing in high-yield securities, if such investments are limited to sound institutions that prudently assess the risks of these investments and diligently maintain diverse portfolios.

However, Federal Reserve Chairman Paul Volcker's views about the need to regulate the purchase of low-grade bonds by federally insured financial institutions should be, and must be, seriously considered by the Banking Committee and this subcommittee.

In his September 18 letter to this subcommittee referred to earlier by the chairman, Chairman Volcker states:

> I believe that consideration should be given to applying some restrictions on the purchase of low-grade bonds to all federally-insured financial institutions. Given the structure of our Federal insurance programs administered by the FDIC and FSLIC, unnecessary risks taken by some institutions place undeserved burdens on other premium payers and potentially on taxpayers.

I understand that the staff of the Bank Board is in the process of preparing fairly stringent diversification requirements for federally insured thrifts holding high-yield securities. I hope that perhaps Ms. Williams will elaborate on the progress and nature of the staff's recommendations in her testimony this morning. I anticipate that may, in fact, be the case.

The Bank Board's regulations must clearly remove the temptation for the thrifts to overreach for high yield, and thereby jeopardize the soundness of their capital and assets.

While to date, high-yield investing has been limited to a relatively small number of thrifts, and does not make up a large percentage of thrift-industry assets, this scenario could change as more thrifts participate in the surging market for high-yield securities. Then FSLIC will surely be called upon to protect the customer's deposits if high-yield bond investments by federally insured thrifts do prove to be unwise.

We are all seriously concerned, as the chairman has indicated, about the growing number of failed financial institutions and the burden that these failures are placing on our Federal Insurance Program. We need to determine and clearly establish if high-yield bonds pose an acceptable level of risk to our insurance funds, when held by thrifts in properly managed portfolios. Also, is it advisable for some thrifts to hold high-yield securities when they are prudently working to bolster their net worth and reduce the likelihood of failure?

If so, what regulations, if any, are necessary?

Those are just some of the obvious questions that this testimony, this subcommittee must address, and I think is a matter of great urgency and importance in the delivery of financial services in our Nation. Mr. Chairman, I hope that some of these questions will be addressed by our witnesses' testimony today.

I'm delighted to have them here to furnish that information, that testimony to us, and thank you for this opportunity to make this statement.

Chairman HUBBARD. Thank you, Congressman Parris.

Now for an opening statement, we call on our friend, Chairman Henry Gonzalez of Texas.

Mr. GONZALEZ. Thank you very much, Mr. Chairman. I don't have any formal statement to make. I wanted to thank you for your wisdom and foresight in calling this and the previous hearings that we've had on the related matters.

I will say for the record after hearing Mr. Parris' presentation, that I think it's the height of nerve, chutzpah, for the Chairman of the Federal Reserve Board, Paul Volcker, to prescribe what he himself hasn't prescribed for his own banking industry in the case of the tremendous overhang that is imperiling, and maybe is at the bottom, of the lamentable situation and the jungle that, with Congress' help, has been created out in the financial markets.

I think we ought to recognize that we've contributed to this very absolute need for survival for the thrifts to engage in some of these investment practices. We went a long way in the name of trying to save them that has resulted in the very thing that we're afraid of today.

I've heard the Chairman of the Federal Reserve Board come before us, in the case of this terrible overhang, where the capitalization of the principal banks of our country has been overextended in these very foolish, irresponsible loans to foreign countries on a very tenuous basis and one which, were it to be committed by a local small bank board, would have led to that bank either pursuing its officers or declaring itself insolvent.

And so, I think that we ought to keep in mind that the Congress has contributed quite a bit in creating this jungle which presently exists out in these financial markets, where the law of the jungle prevails.

It's every man for himself and let the devil take the high most.

I compliment you because I think that in this manner, we can get a better hold as to just where the Congress' responsibility for providing some rules of the game in order to extricate ourselves from this jungle and the law of the jungle.

I also want to anticipate and present my thanks to the members of the panel that have answered your call. In the case of Mr. Pratt, we've had the great privilege of having had him before the committee on many occasions and he did quite an outstanding job as Chairman.

So thank you very much for allowing me to say a few words here for the record.

Chairman HUBBARD. Thank you very much, Congressman Gonzalez.

We've heard Chairman Volcker's opinions commented upon. Perhaps it would be fair at this point, since Chairman Volcker did present his beliefs on this issue to us in the form of a letter dated yesterday, September 18, if I would read those remarks at this time before we hear our witnesses.

Pardon me for delaying the testimony of our witnesses, but the views of the Chairman of the Board of Governors of the Federal Reserve System are sought frequently by our full committee and by our subcommittee. I'll read his remarks at this time.

Dear Chairman Hubbard.

I am pleased to respond to your request for comments on issues relating to the increasing use of high-yield securities (junk bonds). Last year, some $16 billion of such low or unrated bonds were marketed publicly and a similar magnitude was offered privately. Of all public and private issues, an estimated $11 billion were associated with mergers or leveraged buyout transactions. This volume is quite small relative to the $800 billion supplied to all borrowers in credit markets last year; nonetheless, the increased use of these instruments raises important questions about the potential risks assumed by investors and institutions that acquire them.

The Federal Reserve does not believe that debt-financed mergers—be they financed by junk bonds or other borrowing—have any substantial or enduring effects on the availability of funds for other, perhaps more productive, purposes. In a fundamental sense, mergers and leveraged buyouts involve transfers of ownership of existing assets and do not absorb net savings in the economy. Stockholders who sell their shares in such transactions are likely to reinvest proceeds in financial assets either directly by buying stocks or bonds, or indirectly by depositing the funds in a bank or other financial intermediary. Proceeds that flow into deposit accounts expand the pool of funds available for loans and investments at these institutions. Thus, the money is effectively recycled into the markets and access to credit by other borrowers is little affected.

A more important consideration regarding merger financing from the Federal Reserve's perspective is the potential for greater risk exposure of the financial system. The Board of Governors, as a supervisor of banks and bank holding companies and as lender of last resort, has responsibility along with the other regulatory agencies for maintaining the safety and soundness of financial institutions and markets. In this regard, we are concerned about potential financial risks of acquisition activity financed with large amounts of debt.

To date, it appears net credit extended to finance mergers and leveraged buyouts has not resulted in large numbers of problems for the surviving firms or the financial institutions that have extended credit to them. Of course, our economy has been undergoing an expansion that has provided a favorable economic and financial environment for growth, and thus those companies, as yet, have not been tested by adverse economic conditions. Over the past year, the economy has slowed appreciably. Should the earnings prospects of these firms deteriorate unexpectedly, or interest rates rise sharply, some firms may be strained to service heavy debt burdens. In this event, any institutions that provided the credit would in turn be exposed to possibly significant losses.

When the debt instruments used in a transaction are low-rated, it is a further signal of risk. Although low-rated bonds—if valued properly by the markets—may be expected on the average, over time, to provide a yield adequate to compensate for the costs to investors of potential default, this does not mean that during times of economic or financial stress they will not intensify the problems inevitably faced by lenders.

Owing to concerns about the risk and liquidity of these instruments, national banks and State-chartered members of the Federal Reserve System cannot acquire below-investment grade securities for their portfolios. The securities holdings of these institutions have been viewed primarily as a secondary reserve for liquidity that can be used as a source of funds when needed and have long been restricted to those that are marketable and not predominantly speculative (that is, those with qualities equivalent to securities in the top four ratings). Federally chartered S&Ls face similar restrictions, although a portion of their portfolios, up to 1 percent of their assets, may be in low or unrated securities. All of these depository institutions also are subject to restrictions limiting total lending to individual borrowers. State-chartered thrift institutions and nonmember banks, however, are principally subject to supervision and regulation by state authorities, some of which permit the holding of a wider range of corporate debt securities, including low-grade bonds. In principle, further requirements for diversification—across industries as well as across individual firms within industries—would likely help.

While the Board as a whole has taken no position, I believe that consideration should be given to applying some restrictions on the purchase of low-grade bonds to all federally insured financial institutions. Given the structure of our Federal insurance programs administered by the FDIC and the FSLIC, unnecessary risks taken by some institutions place undeserved burdens on other premium payers and potentially on taxpayers.

I hope these comments are useful to you. Please let me know if I can be of further assistance.

Sincerely, Paul Volcker.

Without objection, this three-page letter will be entered in our record as part of our hearing record.

[The letter of Chairman Paul Volcker follows:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

September 18, 1985

The Honorable Carroll Hubbard
Chairman
Subcommittee on General Oversight
and Investigations
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Chairman Hubbard:

I am pleased to respond to your request for comments on issues relating to the increasing use of high-yield securities (junk bonds). Last year, some $16 billion of such low or unrated bonds were marketed publicly and a similar magnitude was offered privately. Of all public and private issues, an estimated $11 billion were associated with mergers or leveraged buyout transactions. This volume is quite small relative to the $800 billion supplied to all borrowers in credit markets last year; nonetheless, the increased use of these instruments raises important questions about the potential risks assumed by investors and institutions that acquire them.

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While the Board as a whole has taken no position, I believe that consideration should be given to applying some restrictions on the purchase of low-grade bonds to all federally insured financial institutions. Given the structure of our federal insurance programs administered by the FDIC and the FSLIC, unnecessary risks taken by some institutions place undeserved burdens on other premium payers and potentially on taxpayers.

I hope these comments are useful to you. Please let me know if I may be of further assistance.

Sincerely,

Paul

Chairman HUBBARD. Anyone here today who wishes a copy of this letter will be provided one upon your request.

We call first on the Honorable Julie Williams, Associate General Counsel and Director of the Corporate and Securities Division of the Federal Home Loan Bank Board.

STATEMENT OF HON. JULIE WILLIAMS, ASSOCIATE GENERAL COUNSEL AND DIRECTOR, CORPORATE AND SECURITIES DIVISION, ON BEHALF OF THE FEDERAL HOME LOAN BANK BOARD

Ms. WILLIAMS. Mr. Chairman, thank you very much.

Mr. Chairman, and distinguished members of the subcommittee, I appreciate the opportunity to appear before you today on behalf of the Federal Home Loan Bank Board to discuss the Bank Board's views regarding high-yield, unrated securities, also known as junk bonds, which are often used to collateralize loans or pay off shareholders in mergers and acquisitions.

With the chairman's permission, I will submit my prepared statement to the subcommittee for the record and summarize that testimony this morning.

Chairman HUBBARD. Without objection, so ordered.

Ms. WILLIAMS. Thank you.

Chairman HUBBARD. And we appreciate it.

Ms. WILLIAMS. Thank you. The rapidly growing high-yield bond market, commonly referred to as the "junk bond" market, has a relatively long history, but has dramatically changed since 1977, when a new type of high-yield bond entered the market. These bonds were rated below investment grade and issued either by relatively new companies or for financing so-called leveraged buyouts.

Of the $40 billion in original issue high-yield bonds outstanding today, the overwhelming proportion was issued since 1977. In 1983 alone, approximately $16 billion was issued, which represents 40 percent of all original issue high-yield bonds outstanding.

With regard to thrift industry involvement in the high-yield bond market, the Bank Board recently conducted a special survey of a sample of FSLIC-insured institutions to identify their holdings of such bonds as of March of this year. The results indicate that FSLIC-insured institutions hold directly approximately $4 billion of high-yield bonds with their subsidiaries holding an additional $1.2 billion.

Most of this dollar volume was held by a small number of relatively large institutions. According to staff estimates, approximately 92 percent of the $4 billion outstanding held directly by institutions was held by State-chartered institutions. More than 80 percent of the $4 billion holdings were at 12 large institutions. Approximately 50 of the 200 largest FSLIC-insured institutions did hold some high-yield bonds, although many of these institutions held very small amounts. Only 3 percent of the smaller institutions had any high-yield holdings.

The Bank Board shares the concern of the subcommittee with regard to need for diversification of these high-yield investments. Some diversification requirements already exist on the holding of corporate debt securities by Federal thrifts, however. Federal associations may place up to 11 percent of their assets in corporate

debt securities, including high-yield bonds and direct commercial loans, but subject to the loans-to-one-borrower limitation of 15 percent of unimpaired capital and unimpaired surplus in the obligations of a single issuer. State-chartered institutions are also subject to these loans-to-one-borrower limits.

The imposition of additional diversification requirements may not be an effective regulatory approach, however, because below investment-grade bonds as a group may be unusually sensitive to an economic downturn.

It is critical to note that it is State-chartered institutions that have the greatest potential to participate in the below investment-grade bond market. Several States grant their thrift institutions greater authority to make commercial loans or invest in corporate securities than is permitted for Federal associations.

California, for example, allows California-chartered savings and loans to invest without limit in corporate debt securities approved by the State S&L commissioner. This investment authority has enabled at least one California institution to invest nearly $1 billion in securities rated at less than BBB by Standard & Poor's or Baa by Moody's.

Generally, the Bank Board's concerns regarding thrift participation in the below investment-grade bond markets fall into two areas. First, the issue of risk to the FSLIC presented by extensive thrift involvement in the below investment-grade bond market and, second, the public policy questions that are raised by the prospect of savings institutions as players in the corporate takeover arena when their statutory mission is to provide housing finance and their preferential position is derived from their subsidized role as housing financiers.

On the first point, below investment-grade bonds may be inherently high risk investments, particularly vulnerable to economic downturn and likely to prove most attractive to distressed institutions that seek high yields, but can least afford losses associated with last-ditch desperate investments.

The Board is currently actively examining this area. Insured institutions have been advised to use caution and to perform careful credit determinations if they make such acquisitions. The Board has also instructed its examination staff to cite in its reports the failure to exercise such caution as an unsafe and unsound practice. Additionally, the staff is studying further regulatory responses to the safety and soundness concerns raised by below investment-grade bonds, as well as other corporate debt securities. These options are set forth at length in my prepared statement and, in general, are directed to ensuring that prudent underwriting practices are followed by insured institutions investing in corporate debt securities.

Thrift involvement in the below investment-grade bond market presents these safety and soundness concerns and also raises a fundamental policy issue regarding the integrity of the thrift regulatory structure and the FSLIC insurance system which supports it.

The basic question is whether funds acquired with the aid of FSLIC insurance should be used in a manner wholly unrelated to the home financing mission that the FSLIC was expressly created to support. The entrepreneurial activity involved when savings in-

stitutions invest in below investment-grade bonds issued to finance takeovers is far afield from the home lending focus of the savings industry. It effectively provides a Federal subsidy and implicates the full faith and credit of the United States in the financing of corporate takeovers.

The Bank Board also believes that the issues presented by below investment-grade bond investments are illustrative of how developments at the State level have exposed critical shortcomings in the statutes governing the FSLIC's ability to assess premiums. Regardless of the risks presented by an institution's investment, the FSLIC currently must charge uniform premiums to all institutions. As an insurance carrier, the FSLIC's resources are backed by the full faith and credit of the United States. Moreover, the FSLIC was created to ensure public confidence in thrifts whose principal role is to serve the needs of housing finance.

No insurance company that intends to maintain its viability can continue to operate successfully unless it works to maintain sufficient reserves to meet its obligations and has the underwriting resources and flexibility necessary to manage effectively the risk that it is likely to incur.

The Board has expressed grave concern regarding the premise that the FSLIC is expected to ensure the diversity and magnitude of risk inherent in the growing universe of operating powers in various States if we cannot apply flexible standards to underwrite appropriately our reserve structure.

Thus, currently, in the context of thrift involvement in below investment-grade bonds, the Board can only try to minimize its risk through prudent regulation.

Mr. Chairman, and members of the subcommittee, that concludes my opening remarks. I thank you again for the opportunity to appear before you and I will be happy to answer any questions you might have on my oral presentation or my written statement.

[The prepared statement of Ms. Williams follows:]

STATEMENT OF

JULIE WILLIAMS

ASSOCIATE GENERAL COUNSEL

OF THE

FEDERAL HOME LOAN BANK BOARD

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE AND

URBAN AFFAIRS

OF THE

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 19, 1985

Mr. Chairman and distinguished members of the Subcommittee, I appreciate the opportunity to appear before you today on behalf of the Federal Home Loan Bank Board ("Bank Board" or "Board") to discuss the Board's views with regard to the use of high-yield, unrated securities which are used to collateralize loans or pay off shareholders in mergers and acquisitions. You have indicated that the Subcommittee is interested, in particular, in the use of these "junk" bonds by savings institutions.

The rapidly growing high-yield bond market, commonly referred to as the "junk" bond (but which I shall refer to as "high-yield" or "below-investment-grade" bond) market, has opened a relatively new investment strategy for savings institutions. High-yield bonds, that is, bonds rated below the top four investment grades, have a long history but recent innovations in the high-yield market have dramatically changed its nature.

Prior to 1977, the high-yield bond market was relatively small, consisting primarily of bonds that were rated investment grade when originally issued and were subsequently downgraded. Beginning in 1977, a new type of high-yield bond entered the market. These bonds were rated below investment grade when first issued, and were issued either by relatively new companies or for financing leveraged buyouts.

The original-issue high-yield bond market is growing rapidly. Of the approximately $40 billion in original-issue high-yield bonds outstanding today, the overwhelming proportion was issued since 1977. This rapid growth did not, however, occur evenly. Approximately $16 billion in high-yield bonds, representing 40% of all original-issue high-yield bonds outstanding and 20% of the total high-yield bond market, were issued in 1983 alone.

In order to obtain a better picture of thrift industry involvement in the high-yield bond market, the Bank Board this spring conducted a special survey of a sample of FSLIC-insured institutions to identify their holdings of such bonds at the end of March. The Board also is requiring quarterly reporting beginning in June 1985 of such holdings by all FSLIC-insured institutions. The June reports currently are being analyzed by the Board and will be finalized in a few weeks.

Based on the Board's recent survey, which covered all large thrifts as well as a sample of thrift subsidiaries and smaller thrifts, the staff estimates that on March 31, 1985, FSLIC-insured institutions held directly $4.0 billion of high-yield bonds. Most of this dollar volume was held by a small number of relatively large thrift institutions. Indeed, more than four-fifths of such holding were at a dozen large institutions. However, approximately 50 of the 200 largest FSLIC-insured institutions did hold some high-yield bonds, although many of these institutions held very small amounts. On

the other hand, the staff estimates that only about 3 percent of smaller institutions had any holdings. In addition, staff estimates that approximately 92% of the $4.0 billion held by FSLIC-insured institutions was held by-state chartered institutions. Furthermore, in addition to the $4.0 billion of high-yield bonds held directly by FSLIC-insured thrifts, subsidiaries of such institutions held somewhat more than $1.2 billion of such bonds.

Below-investment-grade bonds are a relatively recent phenomenon in the thrift industry. With the passage of the Garn-St Germain Depository Institutions Act of 1982, the Congress, for the first time, allowed federal thrifts to make commercial loans and expanded the amount of assets a federal thrift could invest in corporate debt securities such as bonds.

Although the regulations adopted by the Board to implement this corporate debt investment authority generally limit corporate bond investments to those in the four highest grades, investment of up to one percent of assets in unrated debt securities is also permitted. In addition, the general commercial lending authority granted federal thrifts is broad enough to allow investments in corporate debt securities, including high-yield bonds.

As a result, federal associations may place up to 11% of their assets in such bonds and direct commercial loans, subject to the loans-to-one borrower limitation of 15% of unimpaired capital and surplus, in the obligations of a single issuer.

These regulations thus impose some diversification requirements on the holding of corporate debt securities by federal thrifts. However, the imposition of additional diversification requirements may not suffice because below-investment-grade bonds as a group can be unusually sensitive to an economic downturn.

It is, however, crucial to note that it is state-chartered institutions that have the greatest potential to participate, in some instances without the 11% of assets limitation, in takeover financing.

In many states, parity provisions in state savings and loan laws give state-chartered associations the same investment authority as federal associations. Several states, however, grant their thrift institutions even greater authority to make commercial loans or invest in corporate securities. California, for example, allows California-chartered savings and loans to invest without limit in corporate debt securities approved by the state S&L commissioner. This investment authority has enabled at least one California institution to invest nearly a billion dollars in securities rated at less than BBB by Standard & Poor's or Baa by Moody's.

The Board is aware that federal thrifts' new powers were granted for a specific purpose -- as the preamble to the Garn-St Germain Act states -- "to revitalize the housing industry by strengthening the financial stability of home mortgage lending institutions and ensuring the availability of home mortgage loans." It is with this fundamental purpose in mind that the

Board addresses the specific concerns raised by federal thrifts' involvement in below investment grade bond financing for corporate takeovers.

Our concerns fall into two important areas:

--First, the issue of the risk to the FSLIC presented by extensive involvement by thrifts in the below-investment-grade bond markets;

--Second, the public policy questions raised by the role of savings institutions -- that is to say, home mortgage lending institutions that enjoy a preferential position in the marketplace provided by special federal subsidies and other advantages which were expressly fashioned to support a commitment to housing finance -- becoming players in the corporate takeover arena.

On the first score, and without regard to the merits of the takeovers involved, below-investment-grade bonds are a matter of concern because they may be inherently high-risk investments, and some below-investment-grade bond issuers may prove particularly vulnerable in an economic downturn.

Moreover, the default of an issuer could be caused by a variety of other factors that would be difficult to predict. For example, an unexpected decline in the value of a bidder's investment in a target company could severely undercut its financial position.

Unfortunately, high-yielding below-investment-grade bonds are likely to prove most attractive to distressed institutions that need high yields but can least afford losses. In this way, below-investment-grade bonds can present the latest variation for the so-called "end of game play" where a desperate institution may attempt to realize large gains through unduly risky transactions in a last ditch effort to regain its financial footing.

The Board currently is scrutinizing this area. Insured institutions already have been advised to use caution in choosing these investments and to perform careful credit determinations if they make such acquisitions. The Board also has instructed its examination staff to cite in its reports the failure to exercise such demonstrable caution as an unsafe and unsound practice.

Additionally, the staff is studying further regulatory responses to the safety and soundness concerns raised by below-investment-grade bond investments, as well as other corporate debt securities. For example, the staff is studying a requirement that the purchase of any corporate debt security by a savings institution be based on a thorough and documented review of the issuer's capital, earnings, liquidity, creditworthiness, debt burden and all other relevant economic conditions. Such a prudent review would be based on documentation including the issuer's offering circulars, prospectuses, and audited financial statements. This would, in

effect, impose underwriting requirements for purchase of high-yield bonds and other corporate debt securities similar to those standards that both savings institutions and commercial banks should follow in regard to the commercial loans that they originate themselves.

Other regulatory options under study include requiring the issuer to have had a track record of consistent positive earnings over a designated time period reflected in the issuer's audited financial statements.

We also are considering a requirement that institutions only be authorized to acquire corporate debt securities if the issuer's debt service requirements will be covered by its annual pro-forma earnings, factoring in the uses to which new borrowed funds will be put.

In addition, we may address the regulatory treatment of commitments to buy high-yield bonds and other corporate debt securities, since such obligations currently are off-balance-sheet items. A variety of new high-yield bond financings, especially when used for hostile corporate takeovers, involve financing commitments by financial institutions prior to the proposed takeover, with the loans being purchased only if and when the takeover actually occurs. Because commitments to purchase high-yield bonds are off-balance-sheet, they currently are unrecognized in assessing a savings institution's net worth requirements, or in determining whether a federally-chartered institution is complying with commercial lending limits. Th-

commitment to purchase a debt obligation imposes significant economic risk on the institution undertaking the commitment. Therefore, staff is considering ways of treating such obligations to purchase high-yield bonds and other corporate debt securities as if the bonds had already been purchased.

Finally, we are examining the loss-experience in below-investment-grade bonds to determine if further regulatory action is needed. As noted at the outset, the information the Board has received in its new quarterly reports will greatly aid in the assessment of the magnitude of the problem and will help the Board to determine the best regulatory approach to address the situation.

While the safety and soundness questions raised by these investments are important, the trend in thrift involvement in the below-investment-grade bond market also presents a fundamental policy issue regarding the integrity of the entire thrift regulatory structure, and the FSLIC insurance system which supports it.

The basic question is whether funds acquired with the aid of FSLIC insurance should be used in a manner wholly unrelated to the home financing mission the FSLIC was expressly created to support. FSLIC insurance provides a unique benefit to thrift institutions to enable them to perform the task of providing "economical home financing," the central theme of the National Housing Act which created and governs the FSLIC.

While diversification into certain limited activities which may not be directly related to housing was intended in the Garn-St Germain Act to strengthen the ability of savings institutions to better play their primary housing finance role, the Board is gravely concerned that excessive investment by savings institutions in below-investment-grade bonds issued to finance takeovers would in effect provide a federal subsidy -- and implicate the implicit full faith and credit of the United States -- to support entrepreneurial activity which is very far afield indeed from the home lending focus which underpins the support provided by the twelve Federal Home Loan Banks and the FSLIC.

The problem presented by below-investment-grade bond investments, however, must be addressed both as a specific problem and as yet another example of how developments at the state level have exposed critical shortcomings in the statutes governing the FSLIC's ability to assess premiums. Regardless of the risks presented by an institution's investments, the FSLIC must charge it premiums uniform with premiums charged other institutions.

Again, as an insurance carrier whose resources are implicitly, if not explicitly, backed by the full faith and credit of the United States, the FSLIC was created under provisions of the National Housing Act to ensure public confidence in thrifts whose principal role has been, and is, to serve the needs of housing finance in America.

In its role of insurer, the FSLIC serves as a fundamental, critical structural leg of the nation's Congressionally-mandated federal deposit insurance system. As of the end of July, it insured the deposits of 3,214 federally- and state-chartered thrifts.

But no insurance company that intends to maintain its viability can long endure or continue to operate successfully unless it works to maintain sufficient reserves to meet its obligations and has available the underwriting resources necessary to manage effectively the risk it is likely to incur.

As you know, the current statutes of both the FSLIC and the Federal Deposit Insurance Corporation basically provide only for premiums set at a flat rate of one-twelfth of one percent of total domestic deposits. This insurance premium structure was designed to function in a regulatory climate where variation and magnitude of risk were not significant issues, and the Congress did not contemplate those issues when it created these insurance funds.

The statutes regulating both insured banks and thrifts historically served to minimize the risk exposure of the federal insurance funds. Strict, and roughly parallel, controls on the powers of federal and state institutions tailored the risk activity of institutions to fit the finite resources of the insurance funds. The accelerating pace of deregulation at both

the federal and state levels has removed that built-in safety net, without providing the insurers an effective means to deal with an infinitely more volatile risk equation.

In the Board's view, the combination of an insurance system straightjacketed by a flat rate premium system which cannot account for the magnitude or diversity of risk to be incurred, and which requires the FSLIC to shoulder a range of new risks posed by this deregulatory trend, including investment in below-investment-grade bonds, is irrational.

In a deregulated environment, federal deposit insurance actually encourages some managers to take the biggest and riskiest gambles, to obtain the highest possible returns. Here I'm talking about those institutions that heavily leverage their low capital positions to obtain funds and take excessive risks with the funds they attract.

Financial gains are potentially enormous for stockholders and managers if an insured institution takes a big gamble and wins. But a federal agency, like the insurance corporation that the Bank Board heads, ends up picking up most of the cost if the gamble turns out a loser.

We thus have the irrational -- and I believe unsupportable -- result that the FSLIC shoulders the entire responsibility for protecting the funds of insured accountholders in state-chartered thrifts with widely varying powers, without any means of underwriting that risk effectively. And given the

the aggressive trend in some state legislatures, to expand the operating powers for their state-chartered associations, the Board is gravely concerned that we are rapidly reaching the point where the state leg of the dual system is totally divorced from the fiscal consequences to the federal insurance funds -- and ultimately, in the worst case, to the taxpayers of this country.

In my view, it is simply not rational to expect a single, federally-chartered insurance company (FSLIC) with limited and finite resources to insure the diversity and magnitude of risk inherent in the growing universe of operating powers in various states -- if that insurance company cannot apply flexible standards to underwrite appropriately its reserve structure.

In the context of the growing thrift involvement in below-investment-grade bonds, the Board can try to minimize its risks through prudent regulation.

The expansion of investment authority in the Garn-St Germain Act and at the state level has provided additional elbowroom and avenues of profitability for thrifts to strengthen and further support their primary home financing role. However, the Board must strongly resist exploitation of these liberalizations in a manner that disserves the public by vastly increasing the risk of loss to the FSLIC insurance fund. The FSLIC is already coping with mounting and unprecedented strains due to the earnings and capital fragility of the industry and a significant increase in costly, bad-asset related failures.

To some extent, the Board has attempted -- through imposition of regulatory insurance underwriting standards -- to address the increased risk exposure to insured institutions, and, accordingly, to the FSLIC fund, as a result of liberalized operating authorities conferred upon state-chartered FSLIC-insured thrifts by various state legislatures. I should point out that such liberalized authorities go well beyond the thrift deregulation permitted by the Garn-St Germain Act for federally-chartered savings institutions. State Treasuries are held harmless from any risk of loss, or actual losses, incurred from such state-liberalized operating authorities. It is the FSLIC alone which is left to shoulder such burdens. An example of the Board's efforts in this regard is the recently adopted direct investment regulation.

To summarize briefly the rule, it requires a special review by the Board's supervisory staff when the amount of an institution's direct investments in real estate and certain equities exceed certain levels. When proposed increased direct investments present safety and soundness concerns, they may be disapproved. This rule is not a complete solution, however, and by itself cannot relieve the new strains that have appeared in the FSLIC's caseload concurrently with new state asset authorities. Nor was it designed to address the issues and concerns presented by below-investment-grade bonds.

The Board will address the potential problems raised by involvement of thrift institutions in the below-investment-grade bond markets. However, it is important not to lose sight of the fact that the role of thrifts in below-investment-grade bond financing for corporate takeovers not only presents the several specific problems that I have discussed, but also illustrates this broader issue of deposit insurance reform which is of critical concern to the Board.

We have previously come before Congress with legislative proposals for risk-based insurance premiums and other bills designed to ensure that FSLIC insurance is preserved for those institutions that are dedicated to serving the Nation's housing finance needs. The Board's most recent legislative proposals - H.R. 1680, H.R. 2444, S. 759, and S. 1167 - were introduced this year at our request.

An important component of these proposals would be authorization for the FSLIC to assess an additional premium against institutions which engage in activities not authorized for federally-chartered thrifts or which exceed percentage-of-asset limitations applicable to federal thrifts in connection with authorized activities. We believe this reform is a critical starting point -- and only one of a series of necessary measures which must be taken to strengthen the viability of our federal deposit insurance system.

Under H.R. 1680, institutions which have the authority to engage in activities that go beyond those that Congress found suitable to insure for federal savings institutions would pay supplementary premiums to the FSLIC in return for the right to engage in higher risk activities.

We believe that this approach would strengthen the underpinnings of the dual federal-state system. It would reaffirm the validity of diversified powers for healthy institutions, while, at the same time, more fairly allocating the cost of risk to the FSLIC and the risk of loss among member FSLIC institutions.

Through the supplementary premium vehicle, the Board could structure assessments to reflect the total risk equation to the insurance fund given such factors as an institution's capital levels and the nature of the activities undertaken by it. We believe this concept is crucial to infuse greater rationality into FSLIC deposit insurance on a long-term basis. The below-investment- grade bond phenomenon is yet another example of why this legislation is so necessary. The legislation would enable us to underwrite better the risk of high-yield bonds and many other kinds of activities which are being engaged in by certain state-chartered savings institutions.

Mr. Chairman, members of the Subcommittee, I thank you for this opportunity to appear before you and I will be happy to answer any questions you may have on my testimony.

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Chairman. HUBBARD. Thank you very much, Julie Williams.

We welcome to our subcommittee meeting, our colleague and friend, Congressman Doug Barnard of Georgia.

Next we would call upon G. Chris Andersen, managing director of Drexel Burnham Lambert, Inc., of New York. We welcome you, Chris, and your full statement will be entered into the record, if that is ordered. You may proceed.

STATEMENT OF G. CHRIS ANDERSEN, MANAGING DIRECTOR, ON BEHALF OF DREXEL BURNHAM LAMBERT, INC.

Mr. ANDERSEN. Thank you very much, Mr. Chairman. It's a pleasure for me to appear here today.

I am Chris Andersen, managing director of Drexel Burnham Lambert, Inc. I appreciate the opportunity to present Drexel's views before the subcommittee on the subject of savings and loan associations' investments in high-yield bonds, pejoratively referred to as "junk bonds."

High-yield bonds are simply corporate debt issued in the form of securities that are related below investment grade by the rating agencies; that is, they are rated below Baa by Moody's or BBB by Standard & Poor's. The term "junk bonds" was used in an earlier time to describe bonds issued as investment grade securities which were downgraded when the issuers' credit ratings subsequently deteriorated.

Beginning in 1977, however, many new growth companies that did not qualify for investment-grade ratings became original issuers of high-yield bonds. This innovation provided these rapidly expanding companies with access to the public debt market.

It is important that you recognize that only about 675 U.S. companies are rated investment grade by the major rating agencies as compared to 19,000 companies with assets in excess of $25 million which would not qualify for an investment-grade rating.

Chairman Hubbard, in the State of Kentucky, there are 27 public companies, according to our records. Only five of them are investment grade. I doubt that the people of Kentucky, or yourself, would consider the other 22 companies junk.

In addition to providing such companies with funds for expansion and growth, original issue high-yield bonds are frequently used by companies to replace traditional short-term floating rate loans with long-term, fixed-rate capital. From the investor's perspective, the marketability of high-yield bonds provides an added degree of flexibility and liquidity over term loans.

Furthermore, high-yield bonds have an added advantage because they are reviewed by numerous parties in the process of being underwritten and sold. In commercial loans, only the lender reviews the transaction. High-yield bond offerings, however, are reviewed not only by the lender/purchaser, but also by the underwriter or placement agent, legal counsel, accountants, other sophisticated investors and, when applicable, the rating agencies.

The existence of analysts' reports and quoted prices for many high-yield bonds also simplifies investors' and Federal financial institution regulators' task of assessing the value of bonds—eases it with public market quotes in comparison with other types of assets.

Since 1977, more than 350 companies have used the public market to issue $35 billion of new high-yield debt. The ability of those companies to access public market directly enables them to raise capital for expansion and job creation.

It is important to note that far more jobs are created by small and midsize companies than by the industrial giants. In fact, the Fortune 500 corporations, which comprise the bulk of investment-grade companies, have seen net losses in jobs in recent years.

To illustrate my point, in the past 5 years, Drexel Burnham has underwritten high-yield bond issues for MCI Communications, Charter Medical, Kinder-Care Learning Centers. Employment at these 3 companies has risen dramatically over the decade—from 650 to over 10,000 at MCI, from 3,500 to 9,700 at Charter Medical, and from 900 to nearly 11,000 at Kinder-Care.

The premium returns earned by investors on such high-yield bonds significantly outweigh the added risk of loss. Studies have demonstrated that the actual returns average four to eight times the increase in risk. In fact, significantly more money has been lost in the bond markets through the downgrading of investment-grade debt than through defaults on nonrated or low-rated bonds.

Critics generally acknowledge that high-yield bonds have historically been a superb investment, but sometimes questioned the relevance of historical data in predicting the future. Our experience indicates that the credit quality of high-yield bond issuers has improved significantly over the past 5 years.

For example, the proportion of high-yield bonds rated BBB has increased from 21 percent of dollar volume in 1979 through 1981 to nearly 42 percent in 1984. And the average net worth of an issuer has increased from a mere $64 million to $323 million over the same period of time.

Now let us turn to investments in high-yield bonds by S&L's. High-yield bond investments currently account for approximately one-half of 1 percent of the thrift industry's total $1 trillion in assets. Savings and loan associations that buy high-yield bonds have recognized their benefit and have achieved consistently higher returns on their investments with little added increase in overall risk. High-yield bonds provide S&L's with flexible vehicles with which they are able to break into the commercial lending field and diversify their portfolio and earn high returns, just as Congress intended. Unlike traditional commercial loans, which are essentially illiquid, however, high-yield bonds can be resold or traded in a liquid secondary market.

The daily dollar trading volume of high-yield bonds occasionally approaches that of the total on the New York Stock Exchange. This is an extremely important consideration, particularly in this era when financial institutions are taking steps to enhance their liquidity positions.

Despite the excellent investment performance of high-yield bonds, we recognize that they are more complex investments than mortgages and that some S&L's may lack the necessary experience and expertise to evaluate them.

Accordingly, we recommend that the responsible regulatory agencies require thrifts to adopt guidelines for investing in high-

yield bonds which require management to review the creditworthiness of issuers.

We also recommend that investment diversification be required. We understand that the staff of the Federal Home Loan Bank Board is currently in the process of considering guidelines for thrifts' involvement in high-yield and commercial loans.

You also asked whether we believe it is appropriate to place a moratorium or restrictions on the authority of federally insured depository institutions to purchase high-yield bonds.

I believe that any limitation on such authority would be counterproductive and contrary to the public interest. As I've indicated above, high-yield bonds can enhance the earning performance of depository institutions and contribute to improving its financial condition. The evidence is clear that high-yield bonds are no riskier than other types of assets such as commercial loans.

Drexel believes that the most desirable way to proceed is to establish reasonable, prudent guidelines that depository institutions should follow when making investments in these instruments.

There is also a basic misunderstanding concerning how high-yield bonds are used in conjunction with corporate acquisitions and the role that S&L's play in this area. Only a small portion of high-yield bonds have been issued in connection with takeovers. Of the $122 billion in mergers and acquisitions in 1984, less than 2 percent of the funding came from high-yield bonds and only a small portion of this 2 percent was involved in hostile transactions.

Claims have been made that high-yield bonds proposed for the use in takeovers are of low quality.

On the contrary, because of the speed with which such finances must be arranged, investors have demanded that these issues be of higher credit quality than issues providing comparable return.

Accordingly, these transactions have been carefully structured to provide significant protection for the institutional purchaser. In any event, very few thrift institutions hold high-yield bonds issued in connection with takeovers. A recent study conducted by the National Council of Savings Institutions reports that less than 2 percent of the high-yield bonds held by the surveyed thrift institutions related to corporate acquisitions, a very small number, indeed.

Mr. Chairman, you've also asked that I discuss whether credit markets are negatively affected by merger activity financed by high-yield bonds. I believe Chairman Volcker's letter answers that much better than I could.

In conclusion, Mr. Chairman, we believe that experience has demonstrated that high-yield bonds can be used by S&L's to achieve substantially higher returns than they can on other investments with only a slight increase in risk. These increased returns strengthen the net worth of S&L's and enable them to continue to fulfill their primary role of providing funding to the housing industry. We believe that this investment vehicle should remain available as a means of improving the financial health of the savings and loan industry.

Thank you very much.

[The prepared statement of Mr. Andersen follows:]

STATEMENT OF

G. CHRIS ANDERSEN

MANAGING DIRECTOR

DREXEL BURNHAM LAMBERT INCORPORATED

BEFORE THE

SUBCOMMITTEE ON GENERAL OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

September 19, 1985

I am Chris Andersen, Managing Director of Drexel Burnham Lambert Incorporated. Drexel is the country's second largest privately owned investment firm. In 1984 our total corporate underwritings exceeded $10.8 billion. I appreciate the opportunity to present Drexel's views before the Subcommittee on the subject of savings and loan associations' investments in high yield bonds and the benefits that S&L's can obtain from such investments.

Drexel is often credited with developing the public market in high yield debt securities, commonly, and we think unjustifiably, referred to as "junk bonds." There has been significant misinformation regarding the nature of high yield debt, the liquidity of the market, the role these bonds play in corporate takeovers and the advisability of thrift institutions participating in this market. I would like to take this opportunity to clarify the facts, and show how a well-diversified portfolio of high yield bonds can benefit S&L's.

Description of High Yield Bonds

High yield bonds are simply corporate debt issued in the form of securities that are rated below investment grade by the rating agencies. That is, they are rated below Baa by Moody's or BBB by Standard &

Poor's. The term "junk" bonds was used in an earlier time to describe bonds issued as investment grade securities which were downgraded when the issuers' credit ratings subsequently deteriorated. Furthermore, this term has no relevance in today's market to newly issued high yield securities.

Since 1977, many new growth companies that did not qualify for an investment grade rating became original issuers of high yield bonds. This innovation provided these rapidly expanding companies with access to the public debt market. It is important to recognize that only about 675 U.S. companies are rated investment grade by the major rating agencies as compared to about 19,000 companies with assets in excess of $25 million which would not qualify for an investment grade rating. In assigning ratings, Moody's and Standard & Poor's rely heavily on historical data and asset size, which are only partial indicators of future capability to service debt and which do not give sufficient weight to growth experienced by rapidly expanding companies.

The primary function of original issue high yield bonds is to provide mid-sized growth companies with access to the public market for capital. The bonds are attractive to both issuers and investors. They allow

companies to replace private placements traditionally made by insurance companies as well as short-term floating rate bank debt with long-term fixed rate capital. Furthermore, investors recognize that the marketability of high yield bonds affords them an added degree of flexibility and liquidity over term loans.

High yield bonds have an added advantage because they are reviewed by numerous parties in the process of being underwritten and sold. In commercial loans, only the lender reviews the transaction. High yield bond offerings, however, are reviewed not only by the lender/purchaser but also by the underwriter or placement agent, legal counsel, accountants, other sophisticated investors, and when applicable, the rating agencies. Prospective purchasers of outstanding issues also have the advantage of consulting existing holders regarding the issuer's creditworthiness and prospects. The existence of analysts' reports and quoted prices for many high yield bonds also simplifies investors' and federal financial institution regulators' task of assessing the value of bonds, in comparison to other types of assets.

The market for high yield bonds is both broad and deep. There are over 1400 issues outstanding, with

an aggregate market value of between $75 to $100 billion. This represents all high yield bonds, including both original issue and investment grade bonds that have been downgraded. The daily dollar trading volume of high yield bonds occasionally approaches that of the New York Stock Exchange.

The market for original issue high yield bonds has grown steadily since 1977. High yield bonds valued at $14 billion were issued in 1984, representing about 22 percent of total corporate bond underwriting. More than 350 companies have used the public market to issue $35 billion of new high yield debt since 1977. The ability of those companies to access the public debt markets directly enables them to raise capital for expansion and job creation. It is important to note that, far more jobs are created by smaller and mid-sized companies than by the industrial giants. In fact, Fortune 500 corporations, which comprise the bulk of companies rated investment grade, have seen net losses of jobs in recent years.

To illustrate my point, in the past five years, Drexel Burnham has underwritten three high yield bond issues totalling $1.4 billion for MCI Communications, six issues totalling $130 million for Charter Medical and several issues for Kinder-Care Learning Centers. Employ-

ment at these three companies has risen dramatically over the past decade; from 650 to over 10,000 at MCI, from 3,500 to 9,700 at Charter Medical and from 900 to nearly 11,000 at Kinder-Care.

Other rapidly growing issuers of high yield bonds are such firms as Ramada Inns, Republic Airlines, Metromedia, and People Express. Gains in employment in many of the companies that have issued high yield bonds similarly have been dramatic.

High yield bonds are a successful investment vehicle that offers investors an opportunity to obtain an increased return on their investments. The risk-reward characteristics of high yield securities are such that the premium return that is achieved significantly outweighs the added risk of loss. Studies have demonstrated that actual returns average four to eight times the increase in risk. In fact, significantly more money has been lost in the bond markets through the downgrading of investment grade debt than through defaults on noninvestment grade bonds.

A study of investment returns for the periods of January 1980 to June 1984 by Marshall Blume and Donald Klein of the Wharton School of the University of Pennsylvania observed that below investment grade bonds produced

a total return of 13.5 percent a year, almost double the 7.2 percent return for triple-A corporate bonds. The study concluded that, "[i]n the context of a well-diversified portfolio, the risk of lower-quality bonds was no greater than the risk of high-quality bonds." We recommend that investors diversify portfolios of high yield bonds, as do the professionals who dominate this market.

Similarly, a study by Professor Edward Altman of New York University concluded that from 1974 to 1984, although the default rate on high yield bonds was higher than for corporate bonds, the actual losses were only about 1 percent annually because the defaulted bonds retained about 41 percent of their par value. The study determined that even after taking into account losses from defaults, the high yield sector outperformed Treasury bonds by an annual average of about five percent to six percent from 1978 to 1983.

Critics sometimes question the relevance of historic data on performance, citing the recent increases in volume of high yield bonds. Our experience indicates that the credit quality for high yield bond issuers has improved significantly over the past five years. As measured by Standard & Poor's and Moody's bond ratings,

the proportion of new issue high yield bonds rated BB has increased from approximately 21 percent of dollar volume in 1979 through 1981 to nearly 42 percent in 1984. The average net worth of an issuer has increased from $64 million to $323 million over the same period.

Investment in High Yield Bonds by S&L's

Considerable attention has been focused in recent months on the role that high yield bonds play in the portfolios of S&L's. The ability of S&L's to invest in high yield bonds is based upon federal and state legislation that expanded the ability of thrifts to compete and achieve higher returns. For example, the Garn-St Germain Act of 1982 authorized federally chartered thrifts to make commercial loans and invest in corporate debt securities as well as other assets. Congress enacted this legislation in recognition of the benefits in the form of increased earnings and diversification that thrifts can obtain from such uses of their resources. It is undesirable for Congress to reverse the process of expanding the powers of depository institutions, particularly in view of the evidence that indicates that investments in high yield bonds can and do result in stronger institutions.

High yield bond investments currently account for approximately ½ of 1 percent of the thrift industry's total $1 trillion in assets. Savings and loan associations that buy high yield bonds have recognized their benefits and have achieved consistently higher returns on their investments with little additional increase in overall risk. High yield bonds provide S&L's with a flexible vehicle through which they are able to break into the commercial lending field, diversify their portfolios, and earn high returns, just as Congress and the states had intended. Unlike traditional commercial loans, which are essentially illiquid, however, high yield bonds can be resold or traded in a liquid secondary market. This is an extremely important consideration, particularly in this era when financial institutions are taking steps to enhance their liquidity positions.

Despite the excellent investment performance of high yield bonds, we recognize that they are more complex investments than mortgages and that some S&L's may lack the necessary expertise to evaluate them. Accordingly, we would support appropriate regulatory restrictions and investment guidelines for thrifts. We recommend that the regulators require thrifts to adopt guidelines for investing in high yield bonds which require management to

review the creditworthiness of issuers. We also recommend that investment diversification guidelines, which are crucial to the performance of a high yield bond portfolio, be required.

Drexel Burnham believes that appropriate regulatory guidelines aimed at assuring that a proposed investment is evaluated properly will enable thrifts to continue to benefit from the excellent investment performance of high yield bonds. We understand that the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation already possess authority to require Federally insured thrift institutions to comply with guidelines they promulgate. In this regard we understand that the staff of the Federal Home Loan Bank Board is currently in the process of considering guidelines for thrift involvement in high yield bonds and commercial loans.

You have asked whether I believe it is appropriate to place a moratorium or restrictions on the authority of federally insured depository institutions to purchase high yield bonds. I believe that any limitation on such authority would be counter productive and contrary to the public interest. As I have indicated above, high yield bonds can enhance the earnings performance of

a depository institution and contribute to improving its financial condition.

Drexel Burnham believes that the increased earnings S&L's can enjoy from investing in high yield bonds, can bolster their net worth and contribute to the strength of the industry. As thrifts strengthen their financial condition with improved earnings, they can raise additional capital by issuing high yield bonds. Nearly $800 million in capital has been injected into the thrift industry during the past twelve months through the issuance of high yield bonds by thrifts. Drexel Burnham has raised well over two-thirds of that amount.

The evidence is clear that high yield bonds are no riskier than other types of assets such as commercial loans. Like any asset, a depository institution must carefully evaluate the risks involved in the context of the institution's overall portfolio. Drexel Burnham believes that the most desirable way to proceed is to establish reasonable prudential guidelines that depository institutions should follow in making investments in these instruments.

High Yield Bonds and Corporate Acquisitions.

There is a basic misunderstanding concerning how high yield bonds are used in connection with corporate acquisitions and the role S&L's play in this area. Only a small portion of high yield bonds have been issued in connection with takeovers. Of $122 billion used to finance mergers and acquisitions in 1984, less than 2 percent came from high yield bonds. Only a small portion of this amount involved hostile transactions.

Claims have been made that high yield bonds proposed for use in takeovers are of low quality. On the contrary, because of the speed with which such financings must be arranged, investors have demanded that these issues be of higher credit quality then other issues providing comparable returns. Accordingly, these transactions have been carefully structured to provide significant protection to the institutional purchaser. In any event, very few thrift institutions hold high yield bonds issued in connection with takeovers. A recent survey conducted by the National Council of Savings Institutions reports that less than 2 percent of the holdings of high yield bonds by the surveyed thrift institutions related to financing corporate acquisitions -- a very small number, indeed.

Mr. Chairman, you have also asked that I discuss whether credit markets are negatively affected by merger activity financed by high yield bonds. Some people contend that financing mergers drains resources away from other productive uses and therefore is an undesirable use of funds. Nothing could be further from the truth, and this argument has been discredited by such leading institutions as the Federal Reserve and the President's Council of Economic Advisors.

The argument is wrong for a very simple reason. When a merger occurs, the acquirer uses the funds it has raised to pay the shareholders of the acquired company. These funds are then put to work by the former shareholders to make new investments or deposit into the banking system where they are reloaned. In effect, the funds used in connection with acquisitions are recycled back into the credit markets and have no effect on the overall availability of credit in the economy.

Conclusion

Mr. Chairman, as the Subcommittee is aware, the condition of our nation's financial industry is fragile as a result of years of high interest rates and persistent inflation. We believe that experience has demon-

strated that high yield bonds can be used by S&L's to achieve substantially higher returns than they can obtain on other investments with only a slight increase in risk. These increased returns strengthen the net worth of S&L's and enable them to continue to fulfill their primary role of providing funds to the housing industry. We believe that this investment vehicle should remain available as a means of improving the financial health of the S&L industry.

Chairman HUBBARD. Thank you very much, Chris Andersen, for your testimony.

Our next witness is the Honorable Richard T. Pratt, the chairman of Merrill Lynch Mortgage Capital, Inc., of New York, and the former Chairman of the Federal Home Loan Bank Board.

We welcome you, Dick Pratt, to our subcommittee.

STATEMENT OF HON. RICHARD T. PRATT, CHAIRMAN, MERRILL LYNCH MORTGAGE CAPITAL, INC., NEW YORK

Mr. PRATT. Thank you, Mr. Chairman.

Chairman HUBBARD. Your full statement is entered into the record, without objection.

Mr. PRATT. Thank you. It's always a pleasure to be here. Looking at the distinguished panel on the other side of the table, I suspect that that's where the expertise really lies. I've appreciated the dedication with which you have approached these subjects, and I must say that I'm very impressed with the expertise that exists in Congress. I, personally, as a citizen, feel extremely comfortable knowing that people such as I have had the great privilege of appearing before are at the helm. I think it should give us all great comfort.

Chairman HUBBARD. We wish more people outside the beltway would think the way you do about Congress. [Laughter.]

Thank you.

Mr. PARRIS. Inside the beltway as well. [Laughter.]

Mr. PRATT. My position with Merrill Lynch is chairman of Merrill Lynch Mortgage Capital. That may sound like a strange platform from which to speak about the issues of high-yield investments. I manage the national relationship with the thrift institutions and have had some experience in the past with other dimensions of these institutions, including some of the subjects under consideration today.

I might say that the issues which Merrill Lynch deals with, of course, are high-yield instruments, while our competitors may from time to time deal in junk bonds. So that distinction should be noted throughout my remarks. [Laughter.]

In general, the present operating difficulties of the thrift industry have nothing to do with poorly performing junk bond investments. That is clear from the statistics that have been pointed out today. They are instead the result of natural market forces unleashed by changing technology and deregulations, things which, I think ultimately both the regulators and Congress could not control. Deregulation was a natural process of the changing technology of financial institutions and simply changing technology within our country.

Asset and earning problems would have existed if there were no such thing as junk bonds, and they will not go away if junk bonds are eliminated from the thrift portfolio.

Nevertheless, unrated securities exist and to the extent that they have the potential to contribute to the problems of the thrifts and to place added strain on the solvency of the deposit insurance funds, this committee is certainly wise to examine the subject.

Noninvestment grade securities have varying characteristics: the combination of downgraded issues, the issues of emerging companies, and those which are issued in regard to the financing of the takeover or change of control.

It is the nature of financial markets that risk and return are related. The investment in securities having higher credit risk and having commensurately higher returns is not necessarily inappropriate.

Such investments can be part of an intelligent investment strategy. Furthermore, junk bonds are certainly not the only types of investments that carry with them the potential for significant amount of risk. Some real estate loans, for example, have proven to be highly risky, and so singling out junk bonds may be unfair.

In fact, I think a fair examination of the thrift asset problems which have existed would find that predominantly, those asset problems have occurred in investments which were always legal for thrift institutions. And if one looks at the Empire situation in Texas, we find that investments and loans on condominiums and land have always fallen within the purview and supposed expertise of the institutions.

So I think we should not focus unduly on the issue of new authorities and the ability to diversify as the ultimate root problems in thrift institutions or in our other insured financial institutions.

In many respects, high-yield investments may involve less risk because of the liquid secondary market which exists in some of these issues and which allows an institution to turn the asset into cash and provides less of a liquidity risk than many real estate loans.

In the case of financial institutions whose deposits are insured by the Federal insurance corporations, one can argue that there is a separate obligation not to place undue risk upon the insurance function. However, I would also maintain that it is the duty of the regulators in Congress to see that the insurance function is intelligent and tends to generate market discipline in our financial institutions and that we should not necessarily rely on management to do more than that which the regulatory and legislative framework might require.

This is not to say, however, that risks must be avoided entirely in a prudently managed financial institution. In this regard, the experience of commercial banks in the management of diversifiable credit risks—and I emphasize diversifiable here—can be instructive.

Despite some well-publicized failures, commercial banks, on the whole, have been profitable and secure in their lending in these types of areas. If one looks at what commercial banks have historically done, they have made their income from lending on projects and on circumstances which would not qualify to be junk bonds; that is, lending to the local Dairy Queen or auto repair shop, or the local businessman. In most cases, those business firms do not have the credit standing of noninvestment grade securities. And certainly, that has been the backbone of economic growth in the development of our local communities.

Junk bonds can provide a substitute mechanism for institutions that don't have that same expertise because of many of the same qualities that have been talked about here.

Commerical banks, to the extent that we have a problem in the commercial banking field today that is widespread, I think comes from the areas of less diversifiable risk, the areas of foreign loans where one can ask many questions about the judgment both of management and the regulators, the issue of farm loans, which is really difficult to diversify for the local country bank located in a farm area, and perhaps the area of energy loans, which again may have some difficulty in diversification.

These are problems that are endemic to the source of the economy or the part of the economy.

But in terms of their normal business loans, commercial banks have proven that substantial credit risk can be taken in their loan portfolios. We need to examine that experience and apply it to the ability of thrift institutions to have an appropriate portfolio in high-yield securities.

The controlling of risk is a management function. When we speak of the possibility of legislative or regulatory prohibitions for the control of risk, we're really speaking of substituting the judgment of legislators or regulators for that of management.

In view of the self-evident benefits of providing credit to a broad range of American business, it would not be in the public interest to prohibit investment in less than investment quality securities.

The soundness of the deposit insurance system is of overriding concern. Because of this, Congress is right to examine improved regulation or legislation to prevent an inadequate or irresponsible management from unduly shifting what should be the role of private risk capital to the insurance funds. Such legislation or regulation might take several forms. One might require additional risk capital on the part of financial institutions to enable it to absorb losses that may occur from misjudgment or reverses in the below investment-grade market.

I think this is a primary area to focus on, that these investments can certainly be socially productive. They are certainly appropriate. But institutions should have the appropriate amount of ownership capital underlying that investment. The risks should be borne by those who will earn the profits and earn the returns and not by the Federal insurance corporations.

A second might be a limitation in terms of percentage of assets that institutions may invest in below investment-grade securities. Here I don't think it's an issue of safety and soundness; I think it's a value judgment. And if it's Congress' belief that the assets of thrift institutions should be directed in a certain fashion, then they may wish to make some judgments as to limitations in other areas.

I think it's an open question what is more socially productive, the financing of housing or the financing of American business. And that's a debate which will continue to go on. I personally do not see a problem in investment in American business through nonrated securities, but that's really a value judgment and, in my opinion, Congress should consider it a value judgment in their deciding how America's credit-granting system should shape the American destiny.

A third might be a requirement for diversification in such issues. So the reversal of the fortunes of any single issuer would not have a substantial impact on the capital of the financial institutions or the risked exposure of the insurance corporation.

Here, I think, in fact, regulation legislation may be counterproductive, to some extent, at this time. My firm has established what is essentially a mutual fund in high-yield securities which has professional management and which provides wide diversification and, interestingly enough, may be an illegal investment for thrift institutions even though any one of the individual high yield securities within it may be legal.

I think this needs to be addressed so that financial institutions that don't have the size and the professional management to do the total underwriting that might be appropriate on an individual issue have access to widely diversified, professionally managed portfolio of these types of securities.

The control of risk should be oriented toward the provision of market discipline and not take the approach of substituting government or regulatory judgment for management discretion.

As in other areas of the operation of thrift institutions, regulation or legislation may specify that investment in below-grade securities should not be tied to link financing or other arrangements which attempt to use the Government guarantee of deposits as a substitute for what should be the assumption of risk by private investors.

One additional matter that this committee might consider is the problem generated by the ability of State governments to charter and regulate institutions in a more liberal fashion than Federal regulators. Because the insurance risk is not borne by the States, these institutions have a competitive advantage over Federal institutions serving the same markets and can place additional burdens on the deposit insurance system.

Congress and the regulators should squarely face the issue that the deposit insurance corporations ultimately bear the risk associated with the investment practices of insured institutions. It follows that risk control legislation and regulations should be tied to the provision of Federal insurance and not to the authority granting the operating charter.

It certainly makes no business sense to have the risk borne by the Federal insurance corporations and the regulations which control or allow risk to be managed by a party which has no financial responsibility.

I think this is a major structural flaw. I think to a large extent, it's one that can be addressed within the present scheme of law and regulation. It's my belief that the Federal Home Loan Bank Board, by making its regulations, FSLIC regulations, rather than Bank Board regulations, could control many of these issues and so far has chosen not to to this point, though they may be working on it.

It seems to me that you have to have, in terms of risk and return in insurance, all of the insured players playing by the same rules of the game.

Finally, I would suggest that a moratorium on the ability of thrifts to investment in junk bonds would not be appropriate. As I

mentioned earlier in my statement, junk bonds, in and of themselves, are not the problem. Some are very good investments and they provide thrifts with asset diversification, and high yields. Both of these are badly needed. Requirements for thrift capital, diversification and perhaps some overall percentage limitations based on social priorities, can provide an adequate basis for financial institution investment in less than investment-grade securities.

I don't view the junk bond issue as either a crisis or a difficult problem to deal with at this time. I think the tools mainly exist to deal with it in an appropriate fashion which allows the investment in these securities while not placing undue burdens upon the regulatory agencies, and that we simply need some rather simple and straightforward actions to achieve that.

Thank you very much for letting me appear here today.

[The prepared statement of Mr. Pratt follows:]

STATEMENT BY

RICHARD T. PRATT

CHAIRMAN, MERRILL LYNCH

MORTGAGE CAPITAL, INC.

SUBCOMMITTEE ON GENERAL OVERSIGHT

AND INVESTIGATION OF THE

COMMITTEE ON BANKING, HOUSING

AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 19, 1985

Mr. Chairman, members of the committee, it is indeed a pleasure to be here this morning to share with you my views on one of the subjects bearing on the soundness of our thrift institutions.

In general, the present operating difficulties of the thrift industry have nothing to do with poorly performing junk bond investments. They are instead the result of natural market forces unleashed by changing technology and deregulation, coupled with management unused to operating in the new competitive environment. Asset and earnings problems would have existed if there were no such thing as junk bonds, and they will not go away if they were eliminated from thrift portfolios. Nevertheless, unrated securities exist, and to the extent that they have the potential to contribute to the problems of the thrifts and to place added strain on the solvency of the deposit insurance funds, then this subcommittee is wise to examine the subject.

Non-investment grade securities have varying characteristics. The term "junk bond" has become popular because it is catchy; but like many catchy phrases, it is misleading. A so-called "junk bond" is less than investment grade; but because a security is of lesser quality than Treasury or American Tel and Tel bonds does not mean that it is of no value or is inherently unsuitable for financial institution portfolios. These issues can come from several sources. They might be securities of an industrial corporation that started out as investment grade, but because of economic conditions or competitive pressures fell below that category. They might represent financing for new businesses that have sufficient standing to come to the credit markets, but do not have the experience and the track record to warrant their being rated "investment grade." Finally, they might have been issued in connection with a merger or acquisition, or as part of the financing for a leveraged buyout. Junk bonds can vary widely in quality and can represent the debt of a range of corporations from very large, well-established ones to start-up or relatively inexperienced ones. Investment in such instruments, like investment in any situation, requires a careful assessment of the risks in relation to the expected returns.

It is the nature of financial markets that risk and return are related, and the investment in securities having higher credit risk and having commensurately higher returns is not necessarily inappropriate. Such investments can be part of an intelligent investment strategy. Furthermore, junk bonds are certainly not the only types of investments that carry with them the potential for a significant amount of risk. Some types of real estate loans, for example, have proven to be highly risky and so singling out junk bonds may be unfair. In some respects, securities investments may involve less risk because a liquid secondary market provides the opportunity to convert these assets

into cash quickly; a characteristic frequently lacking in real estate investments. In any case, the management of credit risk is one of the primary purposes of financial institutions.

In the case of financial institutions whose desposits are insured by the Federal insurance corporations, one can argue that there is a separate obligation not to place undue risk upon the insurance function. This is not to say, however, that risks must be avoided entirely in a prudently managed financial institution. In this regard, the experience of commercial banks in the management of diversifiable credit risks can be instructive. Despite some well-publicized failures, commercial banks on the whole have been profitable and secure. They have a substantial record in lending to businesses which are at least as risky as an investment in a typical junk bond. A major aspect of commercial banking activity has always been the provision of credit for small and medium sized businesses which in many cases have far less credit standing than the typical corporation having junk bonds outstanding. Investment in a large industrial corporation with less than investment grade securities is in many ways far less risky than the business loan to the local auto repair shop, fast food restaurant, or automobile dealership. The success that commercial bankers have had in making and underwriting such loans indicates that the prudent assumption of substantial credit risk can be accomplished in a highly socially productive fashion.

The controlling of risks is a management function. When we speak of the possibility of legislative or regulatory prohibitions for the control of risk, we are really speaking of substituting the judgment of legislators or regulators for that of management. In view of the self-evident benefits of providing credit to a broad range of American business, it would not be in the public interest to prohibit investment is less than investment quality securities.

The soundness of the deposit insurance system is of overriding public concern. Because of this, Congress is right to examine improved regulation or legislation to prevent an inadequate or irresponsible management from unduly shifting what should be the role of private risk capital to the insurance funds. Such legislation or regulation might take several forms. One might require additional risk capital on the part of the financial institution to enable it to absorb losses that may occur from misjudgment or reverses in the below-investment-grade market. A second might be a limitation in terms of percentage of assets that an institution may invest in below investment grade securities. A third might be a requirement for diversification in such issues so that a reversal of the fortunes of any single issuer would not have a substantial impact on the capital of the financial institution or on the risk exposure of the insurance corporation. The control of risk should be oriented toward the provision of market discipline and should not take the approach of substituting government or regulatory judgment for management

discretion. As in other areas of the operation of thrift institutions, regulation or legislation may specify that investment in below investment grade securities should not be tied to linked financing or other arrangements which attempt to use the Government guarantee of deposits as a substitute for what should be the assumption of risk by private investors.

One additional matter this committee might consider is the problem generated by the ability of state governments to charter and regulate institutions in a more liberal fashion than federal regulators. Because the insurance risk is not borne by the states, these institutions have a competitive advantage over federal institutions serving the same markets and can place additional burdens on the deposit insurance system. Congress and the regulators should squarely face the issue that the deposit insurance corporations ultimately bear the risk associated with the investment practices of insured institutions. It follows that risk control legislation and regulation should be tied to the provision of federal insurance, and not to the authority granting the operating charter. Equity requires that institutions that are charged the same federal insurance premiums should be governed by the same rules of risk bearing. If states wish to allow greater risk taking, then insurance premiums for those institutions should be increased or otherwise differentiated. On the other hand, if premiums are to be the same for state and federal charters, then the ability to impose risk upon the system should also be the same for both federal and state chartered institutions. The present system, in which the risk of asset management activities is borne by the federal insurance corporations while the regulations for asset investments are controlled by the states, is inherently unworkable.

Finally, I would suggest that a moratorium on the ability of thrifts to invest in junk bonds would not be approriate. As I mentioned earlier in my statement, junk bonds in and of themselves are not the problem. Some are very good investments, and they provide thrifts with asset diversification and high yields: both of these are badly needed. Requirements for risk capital, diversification and perhaps some overall percentage limitation based on social priorities can provide an adequate basis for financial institution investment in less than investment grade securities.

-In summary, securities of less than investment grade can be productive and have a legitimate place in thrift portfolios.

-The protection of the deposit insurance funds is of paramount importance, but regulation to accomplish this should be based upon market discipline rather than the substitution of regulators' judgment for management judgment.

-Appropriate regulation might take the form of requiring additional risk capital; providing for adequate diversification; and setting a limitation on percentage of assets devoted to high risk investment.

I hope that these remarks have been helpful to the committee. I will be pleased to attempt to answer any questions.

HIGH YIELD SECURITIES

The Market of High Yield Securities

High yield bonds, in the broadest sense, include all issues that trade more on their credit characteristics than on the general level of interest rates. Fixed income analysts and portfolio managers generally define "high yield" bonds as bonds of issuers rated below investment grade (Baa/BBB) i.e. when the issuer is rated Ba1/BB+ or lower by Moody's and/or Standard & Poor's or are non-rated.

The high yield market is large, diverse, dynamic and growing. In the past it tended to include only straight industrial and finance issues rated below investment grade; today it also encompasses bonds of utility companies, municipalities, preferred stocks, high premium convertible bonds, private placements with registration rights and even bonds and insurance loans to corporations, individuals and foreign countries. In light of the enormous problems banks have had with their loans, i.e., agricultural, energy-related, and foreign loans, and given their willingness to sell this debt, the high yield market could conceivably be several hundred billion in size. If we exclude bank debt we estimate the total high yield market, both public and private, at approximately $100 billion.

The Evolution of High Yield Securities.

Before 1977, the market consisted mainly of conglomerate bonds, downgraded investment grade issues and transportation issues, i.e. railroads and airlines. Beginning around 1977, many more companies which traditionally obtained their long term capital from the private placement market, commercial banks or equity markets began issuing lower rated subordinated debt. The main reasons were:

1) the Investment Company Act of 1940 created specialty pools of capital to investment in these securities;
2) companies enjoyed increased freedom from restrictive covenants;
3) provision of an alternative to equity financing;
4) to establish or maintain presence in the public market.

Between 1977 and 1984, approximately 350 industrial and finance companies issued approximately $34.4 billion principal

amount of high yield debt. This figure does not include the large number of investment grade issues which were downgraded, mostly "smokestack" industries and nuclear-involved utilities.

New Issue Debt in the Low Grade Market

Year	# of Issues	Cumulative # Issues	Dollar Volume	Cumulative $ Volume	Avg. Size New Issue
1977	26	-	$ 1,076	-	$ 42.1
1978	60	86	2,107	$ 3,183	35.1
1979	51	137	1,586	4,769	31.3
1980	42	179	2,004	6,773	47.7
1981	27	206	1,250	8,023	46.3
1982	48	254	3,086	11,109	64.3
1983	84	338	7,432	18,541	88.5
1984	127	465	15,790	34,331	124.0
1Q85	16	481	1,030	35,361	64.4

5 year compound annual growth rate: 58.35%
3 year compound annual growth rate: 132.89%

The growth of the high yield market over the past 5 years has been dramatic. The expansion has been accompanied by a vast increase in the numbers and diversity of investors attracted to this market, including pension funds, insurance companies, mutual funds, individuals and thrift institutions. At year end 1984, the publicly traded high yield non-convertible fixed income debt issues outstanding totalled approximately $43 billion while outstanding publicly traded convertible debt totalled another $11 billion. We estimate the outstanding corporate bond market at $413.3 billion as of year end 1984, comprised of $391.7 billion straight debt and $21.6 billion convertible. The high yield sector is now approximately 13% of the total public corporate bond market.

The absolute growth of high yield financing has been impressive over the past five years, growing at a 58% compound annual rate. In addition, the relative growth of junk bond financing as a percentage of total corporate debt has also been substantial, increasing from 5.5% of the total in 1980 to 27.6% of the total in 1984.

New Issue Volume by Quality

Year	High Grade+ # Issues	High Grade+ $ Volume	Low Grade* # Issues	Low Grade* $ Volume	Low Grade as % # Issues	Low Grade as % $ Volume
1980	335	$ 34,459	42	$ 2,004	11.1%	5.5%
1981	307	38,591	27	1,250	8.1	3.2
1982	392	41,576	48	3,086	10.9	6.9
1983	294	32,507	84	7,432	22.9	18.6
1984	242	40,920	129	15,607	34.8	27.6

+ AAA through BBB, inclusive
* BB through NR, inclusive, non-convertible debt.

The "high yield" market consists of high yield or low grade convertible debentures and preferred stock, and has been active over the past 5 years. It is our opinion that this segment, particularly preferred stock new issues, could see substantial growth in 1985 and 1986.

New Issue Lower Rated Convertible Debentures and Preferred Stock 1979 - 1984

	Convertible	Preferred Stock	Total	% Change Per Year
1979	$ 414 mil.	$ 586 mil.	$ 1,000	--
1980	2,598	801	3,399	+ 340%
1981	1,346	232	1,578	(54)
1982	1,561	1,170	2,731	+ 73
1983	2,338	2,952	5,290	+ 94
1984	1,213	662	1,875	(65)

Participants in the High Yield Market.

Growth of the high yield market has occurred in three basic phases. During the 1960s and up to 1975, major participants included individuals, high yield mutual funds and a limited number of insurance companies. Begininng around 1975 and for the remainder of the decade pension funds, more life and casualty insurers, high grade and equity mutual funds and more individuals got involved. Since 1980, the high yield market has broadened to include all types of domestic and foreign financial institutions, including savings instituions and commercial banks. Pension funds and insurance companies have become more deeply involved. It is estimated that as many as 100 of the Fortune 500 pension

funds are currently investing in high yield bonds either direct or indirectly.

The actual size of the high yield mutual fund market is approximately $9 billion, up over 70% in the last 2 years.

Performance Measurement/Risk.

Measuring the performance of the high yield sector has always been difficult. W. Braddock Hickman studied the 1900-1943 period which included the Great Depression, and found that 1.7% of the outstanding corporate debt, both private and public, defaulted on an annual basis. Hickman's conclusion was that low grade corporate bonds outperformed investment grade issues by over 300 basis points in a much lower interest rate environment. T.R. Atkinson, covering the 1944-65 period, concluded that default rate was less than .1% annually for all outstanding corporate debt.

An update of the Atkinson study for the period 1966-77 concluded that for publicly held corporate debt, the default rate averaged .15% per year.

When investing in high grade bonds, the cost of credit deterioration is usually a more important consideration than the cost of bankruptcy if one uses the market value of his investments. When Chrysler encountered severe credit problems in the earlier part of this decade and investors became concerned about the viability of Ford Motor Corp. and Ford Credit, the decline in the market value of the debt securities, excluding changes in price due to changes in interest rate levels, exceeded the total loss from all bankruptcies during the preceding 12 months. The same analogy could be cited with the nuclear-involved utilities in late 1984.

Spreads in the High Yield Market.

Yields in the high yield debt market generally fall between 300-500 basis points over the U.S. Treasury market. High yield bonds offer the opportunity for significant incremental yield without undue risk. The spread of the Merrill Lynch Low Grade Index to yields on the Merrill Lynch high grade portfolio is as follows:

1981	257 basis points
1982	318
1983	224
1984	353
3/25/85	314

Incremental Returns from High Yield Investments.

The incremental return from high yield bonds is substantial. One dollar invested at 11% in government bonds vs. an investment at 14% in high yield debt illustrates the point:

11% for 10 years = 284%
14% for 10 years = 371%

Incremental returns in the high yield market have been available since the beginning of this century and are available today.

The Evolution of the High Yield Product.

The high yield market has been on the leading edge of innovative financing techniques for the past 10 years. Starting from a conventional base of 15-20 year fixed coupon bond issued at par, we have seen a host of modifications and refinements. The following is a representative list of the innovative financing techniques developed or perfected in the junk bond market:

Original issue deep discount bonds
Bonds/warrant units to purchase common stock
Bond/"equity" units for private companies
Commodity-related bonds
Variable rate bonds
Variable rate preferreds
Variable rate exchangeable fixed rate bonds/preferred
Private placements with registration rights
Increasing rate preferred stock
Mortgage bonds with coupon based on cash flow

High Yield Bonds 1985 and Beyond

Beginning in 1984, the high yield market began to undergo another mutation. Prior issuers of high yield debt began to participate in the hostile takover financings and, in addition, the proliferation of leveraged buyouts, both friendly and hostile, has resulted in the creation of below investment grade paper. In 1984, the leveraged buyout of Metromedia resulted in the creation of $1.9 billion of high yield bonds - this was just

the beginning.

To date, high yield financing has been issued in the following transactions:

Completed Takeover Transactions

Company	Transaction	Total Financing
AMR/Coastal Corp.	Hostile Takeover	$ 600.0 mil.
Triangle/National Can	Hostile Takeover	395.0
Phillips/Mesa	Financial Restructuring	1,500.0
Northwest/Farley	Leveraged Buyout	600.0
Unocal/Mesa	Financial Restructuring	1,631.0
		$ 4,726.0

The attraction for the corporate investor is the return. There are few businesses that can generate a 15% return on assets. By investing $20-30 million in a High Yield Bond-financed takeover of a major corporation, the corporate investor will make 15% on just the interest/dividend payments and will probably receive incremental returns above 15% from an equity participation or an increasing rate or dividend. It is our opinion that in 1985, approximately $20+ billion of new high yield bonds and high yield preferred stock will be issued. Most of this paper will be initially issued as private placements with registration rights. Not only will the paper be issued to finance hostile takeovers, but a substantial amount of additional high yield paper will be issued by corporations seeking to avoid a hostile takeover. The recent announcement by Atlantic Richfield (ARCO) to restructure itself is a prime example. There could be 3-4 additional major oil companies making similar restructuring moves such as ARCO's.

At the present time we can identify over 250 corporations, individuals and financial institutions actively investing in the hostile takeover transactions - another 250 would probably be willing to participate in friendly takeovers or friendly leveraged buyouts.

Total creation of high yield securities in 1985-86, barring a major recession, will probably approach $50 billion.

John A. Frabotta
Vice President
May 24, 1985

Chairman HUBBARD. Thank you very much, Dick Pratt.

Mr. BARNARD. May I have permission to interrupt for 1 second?

Chairman HUBBARD. Certainly, Congressman Barnard.

Mr. BARNARD. First of all, Mr. Chairman, I want to compliment you on the hearings that are being held today on this very interesting subject because I think it will bring more light onto it than has been exposed in the past, and certainly, the experts that are here today with us at this table can provide us with this very valuable information.

As so often happens, there are conflicts in committee meetings. Right now, there's another one going on of which I'm just as interested in—deposit insurance reform. So, I just wanted to say at this point that I have also read Dr. Altman's statement and I would say, I guess for the first time in my experience in Congress, I do agree with all of what you-all are saying today.

I have no questions and I hope that you will excuse me with understanding.

Thank you.

Chairman HUBBARD. Thank you. It is true that the Financial Institutions Subcommittee—another subcommittee of our Banking Committee—is meeting simultaneously with us in the full Banking Committee, room 2128. Chairman St Germain of our full committee is chairman of that subcommittee.

Thank you, Congressman Barnard, for being with us at our hearing.

Now we hear from Dr. Edward I. Altman, professor of finance and chairman, Masters of Business Administration Program, at New York University.

Ed Altman, we welcome you to our subcommittee. Your full text is entered into the record, without objection.

STATEMENT OF EDWARD I. ALTMAN, PROFESSOR OF FINANCE AND CHAIRMAN, MASTERS OF BUSINESS ADMINISTRATION PROGRAM, NEW YORK UNIVERSITY

Dr. ALTMAN. Mr. Chairman, and members of the subcommittee, thank you very much for inviting me today.

I am pleased to submit this statement to the subcommittee's hearings on high-yield securities. I believe that the most appropriate contribution from me to these hearings is to provide objective background information on the performance of high-yield bonds in the financial market over the last decade or so, and hopefully, to assist in your important deliberations.

I will also offer some alternatives in view of these performance observations.

The primary sources for these materials comes from two studies that we have recently completed—one on the default rate experience on high-yield debt securities published in March of this year, and the second, "The Anatomy of the High-Yield Debt Market," which was just published yesterday. And so I'm pleased that I can enter those comments into these proceeds.

The firm of Morgan Stanley & Co. sponsored these studies, but I would like to mention that the following comments are my own and do not reflect those of any person or any other organization.

A third study on the portfolio strategy performance of high-yield debt securities, which is one of the subjects of your questions, is in preparation at this point in time and will be published within approximately 1-month's time.

Attached to these introductory comments are detailed data on high-yield debt securities performance drawn from the two aforementioned studies. I will refer to a few of those charts in my formal comments, but won't belabor all the numbers and charts. That is, of course, for you and your staff to look over at your convenience.

Since these works, the prior ones I mentioned, do not focus at all on the first question that you hope to explore today—namely, the impact of junk bond financed merger activity on credit markets—I will not address that question as it appears that the other witnesses also have not, with the exception of Chairman Volcker.

I do believe, however, that my prior works have potential bearing on the other two questions of inquiry and I will then restrict my comments to those other two areas of inquiry.

First, on the restrictions on investments. Based on the historical risk return performance of high-yield bond portfolios, I find no evidence to support an outright moratorium on investing in high-yield bonds. Rates of return net of default—and I emphasize that "net of default"—over the past 10 years have in most years far outdistanced rates of return on risk-free securities or investment grade securities. And I refer you to exhibits 1 and 2 of the appendix in the back which show clearly the spreads between high-yield bonds and long-term Government bonds and also the rates of return differentials or spreads between these two different investment class securities.

While we do not find evidence of excessive risk on these investments—namely, the high-yield bonds—either in terms of the traditional mean-variance framework—or in terms of the average annual defaults on high-yield securities, I can understand the committee's concern given the fact that the historical default rate on high-yield bonds is certainly higher than investment-grade corporate debt securities.

The question is can the documented experience in this default rate area be of any relevance to your deliberations on whether federally insured institutions should in some way be regulated in this increasingly popular investment area?

One possible route to take rather than the outright restriction or moratorium proposal is to treat investments in high-yield bonds in a similar manner as traditional loans are treated in thrifts and other lending institutions. Since loans for real estate development, home mortgages, commercial and industrial purposes, and consumer finance can and do result oftentimes in default in principle and interest to lenders, it is traditional for these institutions to set up reserves for loan losses. These reserves, in effect, set aside capital to cover expected losses.

Why not treat all investments, including those in securities, in a similar manner?

Where the risk of default is not present, no reserves need to be set up—for example, on risk-free bonds. Where the risk of default is present and we can fairly accurately observe and measure the

default rate experience, it might be prudent to utilize such information to set up these reserves. This would, of course, discourage investments by those institutions which have an existing fragile capital base. But this is precisely the type of institution that public regulators are concerned about.

Our analysis has shown that the default rate on high-yield bonds has been 1.52 percent on an average annual basis over the period, 1974 to 1984, and the individual years of that calculation can be found in table 5 of the appendix.

This assumes that investors purchase those bonds at par value. If we consider, however, that investors do not lose everything when a bond defaults, but they do forego at least one interest payment on default, we estimate that the net default rate on an average annual basis has been approximately 1 percent over the period, 1974 to 1984, on high-yield debt securities. This is based on the observation that debt securities, on average, sell at 41 percent of par value shortly after default.

In other words, they don't go to zero and, as has been pointed out, there is a secondary market where these securities can be liquidated even after default.

It, therefore, seems reasonable to me that if regulators decide to treat risky investments in a manner similar to risky loans, that a 1-percent loss reserve would be appropriate.

Incidentally, this 1 percent turns out to be approximately the loss rate reserve that commercial banks tend to set aside for their loan portfolios in commercial and industrial loans.

Investment managers, in turn, would have to consider—and I'm talking about investment managers now for the thrift institutions—would have to consider whether this explicit reserve was justified given the expected returns from such investments. Recall that the expected yields from these high-yield debt securities have ranged from 300 to 500 basis points, or 3 to 5 percent, above risk-free securities and returns net of defaults have been even more attractive.

If these defaults and losses continue to manifest, then the loss reserve would have adequately covered that contingency.

I want to make it clear, however, that I am not necessarily advocating the setting up of a loan loss or investment loss reserve on risky investments. I do not have the experience to trace through the impact of such additional reserves on our financial institution systems, particularly the thrifts. I do not see any hard evidence, however, for the outright restriction or moratorium on such investments.

Loan loss reserves would certainly be a compromise between total restrictions and the current situation.

Incidentally, a loan loss reserve system would seem to be appropriate not only for high-yield or junk bonds, but for all risky investments where you can very accurately measure what has been the default rate experience on those securities.

And I might add, which I didn't know before, that I'm not so sure that these comments on loan loss reserves are that much different than what Richard Pratt, has just talked about in terms of setting aside capital, because, in effect, they really do the same thing.

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The next area that I'd like to address is the trend in credit quality on new high-yield issues in the high-yield markets.

There's been a great deal of speculation about the credit quality trend in new high-yield issues since this market expanded greatly, particularly in the last 6 or 7 years. My own analysis, utilizing a corporate distress prediction model that I developed, known as the Zeta model, shows that new high-yield issuers have experienced an upward—that is, a better quality trend—in recent years, with the exception of 1983. And I can talk about 1983, if the committee would like to later on.

Zeta is a model combining seven financial indicators of corporate performance into a single, overall summary statistic which is used in order to classify a company into financial profiles similar or not to firms that have had distress in the past.

Developed in 1977 by myself and others, it is now a fairly well established credit risk tool used by professionals across the country. This credit-scoring approach is essentially objective and unambiguous and is therefore unencumbered by emotionally driven conclusions.

Table 7 of the appendix lists the median and mean Zeta scores of new issuers in this high-yield bond area since 1978. In that year, 1978, the central tendency of new high-yield issuers was roughly equivalent to the average of a single-B rated debt—that's one of the high yield or junk bond categories.

In other words, in 1978, new issues were about the same as a B-rated security, which is a quite risky security.

Since that date, the median new issuer's Zeta score has increased fairly consistently, while the existing population of low-rated debt, the BB/B average, has deteriorated somewhat. Exhibits 4 and 5 of the appendix show these trends very clearly. I conclude that while the overall credit profile of a new issuer, high-yield debt is still in the risky zone. So we are still talking about risky securities, averaging around a Zeta of a score of around zero. We have observed an overall improvement in this group both in absolute terms, and relative to existing issues.

This does not mean, however, that new high-yield bond issues are without significant individual default risk. The distribution of Zeta scores is quite wide with about 15 percent of the new issuers falling deeply into what I consider the highly distressed zones. Clearly, the investment managers should adopt either a rigorous credit analytical framework and/or effective diversification program for investing in and monitoring high-yield debt securities.

And some recent tests have shown that you can essentially all but eliminate default risks by adopting some fairly conservative credit standards in your investment program. That is addressed in the appendix as well.

Finally, on diversification issues.

I'm quite sympathetic to the virtues of diversification, as I think everybody else has talked on this panel so far this morning, as a means to reduce overall portfolio risk. This is especially true for risky debt securities where individual default risk is considerably higher than on investment-grade debt. Since we cannot expect that all portfolio managers will exercise a prudent, sophisticated approach to this objective, some type of incentive or even penalty is

perhaps appropriate. An ad hoc approach, such as one based on limiting the percentage invested in any one security or any one industry is not really based on any precise examination of the situation, I believe.

I have not had time myself, or the experience, to examine this in depth. But I think that that would be more of an ad hoc solution, but perhaps one that's certainly better than no diversification at all.

An alternative approach is to mandate increases in capital requirements—for example, haircuts—on investment amounts in specific securities which exceed a prescribed percentage.

The results are clear, I believe, however. Favorable risk versus return performance attributes can be accomplished through diversification of a composite high-yield debt security portfolio. Sensing the market potential for reducing portfolio risk in this area, researchers, and I'm sure practitioners representing most of the major investment banking firms, are also now developing sophisticated techniques to hedge against losses in the investment sector.

Mr. Chairman, this concludes my formal comments before the committee. Thank you very much for the opportunity to appear here today.

[The prepared statement with attached appendix of Dr. Altman follows:]

FOR RELEASE ON DELIVERY

STATEMENT BY

DR. EDWARD I. ALTMAN
PROFESSOR OF FINANCE
CHAIRMAN, MBA PROGRAM
NEW YORK UNIVERSITY

ON

HIGH YIELD SECURITIES
(JUNK BONDS)

TO THE
SUBCOMMITTEE ON GENERAL OVERSIGHT & INVESTIGATIONS
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 19, 1985

Introduction

I am pleased to submit this statement to the Subcommittee's hearings on high yield securities. I believe that the most appropriate contribution from me at these hearings is to provide comprehensive, objective background information on the performance of high yield bonds in the financial market over the last decade so as to assist in your important deliberations I will also offer some alternatives in view of these performance observations.

The primary sources for these materials come from two studies we have completed on **The Default Rate on High Yield Debt Securities** (March 1985) and **The Anatomy of the High Yield Debt Market** (September 1985). The latter has just been released. The firm of Morgan Stanley & Co., Incorporated, sponsored these studies. A third study on **Portfolio Strategy Performance of High Yield Debt Securities** is in preparation but will not be in publishable form for about one month.

Attached to these introductory comments are detailed data on High Yield debt security performance drawn from the two aforementioned studies. Since these works did not focus at all on the first question that you hope to explore today, namely, the impact of "junk bond financed merger activity" on credit markets, I will not address this question.

I do believe that our prior works have potential bearing on the other two avenues of inquiry dealing with the questions of restrictions on federally insured financial institutions to invest in high yield bonds and diversification requirements on these investments.

The comments made at this hearing are my own and do not reflect the viewpoints of any other person or organization.

Restrictions On Investments

Based on the historical risk-return performance of high yield bonc portfolios, I find no evidence to support an outright moratorium on investing in high yield bonds. Rates of return net of default, have, in most years, far outdistanced rates on risk-free or investment grade securities (see Table 1 and Exhibits 1 and 2 in the Appendix). Statistical tests now being completed also show that these excess returns enjoyed by investors in a diversified portfolio of high yield bonds are statistically significantly superior to "investment grade" and risk free securities.

While we do not find evidence of excessive risk on these investments, either in terms of the traditional mean-variance framework or in terms of the average annual defaults on high yield securities, I can understand the Committee's concern given the fact that the historical default rate on high yield bonds is certainly higher than investment grade Corporate debt securities. Can the documented experience in this default rate area be of any relevance in the deliberations on whether federally insured institutions should in some way be regulated in this increasingly popular investment area?

One possible route to take, rather than the outright restriction or moratorium proposal, is to treat investments in high yield bonds in a similar manner as traditional loans are treated in thrifts and other lending institutions. Since loans for real estate development, home mortgages, commercial and industrial

purposes and consumer finance can result in default and loss of principal and interest to lenders, it is traditional to set up reserves for loan losses. These reserves, in effect, set aside capital to cover expected losses. Why not treat all investments, including those in securities, in a similar manner? Where the risk of default is not present, no reserves need to be set up, e.g., on risk free bonds. Where the risk of default is present and we can fairly accurately observe and measure the default rate experience, it might be prudent to utilize such information to set up reserves. This would, of course, discourage investments by those institutions which have an existing fragile capital base, but this is precisely the type of institution that public regulators are concerned about.

Our analysis has shown that the default rate on high yield bonds has been 1.52% on an average annual basis over the period 1974-1984 (Table 5). This assumes that investors purchased the bonds at par. If we consider, however, that investors do not lose everything when a bond defaults, but they do forego at least one interest payment at default, we estimate that the net default rate, on an average annual basis, has been approximately 1.0 (one) % over the period 1974-1984. This is based on the observation that debt securities, on average, sell at 41% of par shortly after default (p. 1 of the appendix).

It therefore seems reasonable to me that if regulators decide to treat risky investments in a manner similar to risky loans, that a 1.0% loss reserve would be appropriate. This

incidentally, is approximately the loss rate reserve percentage that commercial banks utilize on their loan portfolio. Investment managers, in turn, would have to consider whether this explicit reserve was justified given the expected returns from such nvestments. Recall that expected yields from these high yield debt securities have ranged from 300 to 500 basis points (3% to 5%) above risk free securities and returns (net of defaults) have been even more attractive. If these defaults and losses continue to manifest, then the loss reserve would have adequately covered the contingency.

I want to make it clear that I am not necessarily advocating today the setting up of loan-loss reserves on risky investments. I do not have the experience to trace through the impact of such additional reserves on our financial institutions system, particularly the thrifts. I do not see any hard evidence, however, for the outright restriction or moratorium on such investments. Loan loss reserves would certainly be a compromise between total restrictions and the current situation. Incidentally, a loan-loss reserve system would seem to be appropriate for all risky investments if adopted for junk bonds.

Trend In Credit Quality on New High Yield Issues

There has been a great deal of speculation about the credit quality trend in new high yield issues since this market expanded greatly, particularly in the last six or seven years (Table 3). My own analysis, utilizing a corporate distress prediction model known as the Zeta ™ model, shows that new high yield issuers have experienced an upward (better quality) trend in recent years

(with the exception of 1983). Zeta is a model combining seven (7) financial indicators of corporate performance into a single, overall summary statistic in order to classify a company into financial profiles similar to firms which, in the past, have, or have not, suffered serious financial distress. Developed in 1977 by myself and others, it is now a well established credit risk tool used by professionals across the country. This credit scoring approach is essentially objective and unambiguous and is therefore unencumbered by emotionally driven conclusions.

Table 7 of the Appendix lists the median and mean Zeta scores of new issuer firms. In 1978, the central tendency of new high yield issuer scores was roughly equivalent to the average single-B rated debt. Since that date, the median new issuer Zeta score has increased fairly consistently while the existing population of low-rated debt (BB/B average) has deteriorated somewhat. Exhibits 4 and 5 show these trends clearly. I conclude that while the overall credit profile of new issuer, high yield debt is still in the risky zone, averaging around a Zeta of zero, we have observed an overall improvement in this group both in absolute terms, and relative to existing issues.

This does not mean, however, that new junk bond issues are without significant individual default risk. The distribution of Zeta scores is quite wide with about 15% of new issuers falling deep into the negative Zeta zone of below -3.0. Clearly the investment manager should adopt either a rigorous credit analytical framework and/or an effective diversification program for investing in and monitoring high yield portfolios.

Recent tests have shown that stringent credit evaluation procedures, such as the Zeta score analysis combined with conservative cutoff score criteria, can reduce default experience significantly. Table 8 shows that all but one recent default could have been avoided with a Zeta criterion of at lease + 1.0. Such stringent techniques reduce, however, the ability of the portfolio manager to diversify across a large number of debt securities since the relevant portfolio set is reduced. Our tests do show that, when adopting the Zeta criterion, there is only a negligible reduction in realized returns compared to the return on the entire High Yield Debt composite. More explicit results on these comparisons will be published shortly.

Diversification Issues

I am quite sympathetic to the virtues of diversification as a means to reduce overall portfolio risk. This is especially true for risky debt securities where individual default risk is considerably higher than on investment grade debt. Since we cannot expect that all portfolio managers will exercise a prudent, sophisticated approach to this objective, some type of incentive or penalty is perhaps appropriate. An ad-hoc approach such as one based on limiting the percentage invested in any one security or industry is not based on any precise examination of the situation, and I have not had the time or experience to examine this issue in any depth. An alternative approach is to mandate increases in capital requirements (e.g., haircuts) on investment amounts in specific securities which exceed a prescribed percentage.

The results are clear, however. Favorable risk vs. return performance attributes can be accomplished through diversification of composite, high-yield debt securities. Sensing the market potential for reducing portfolio risk in this high yield area, researchers are also now developing sophisticated techniques to hedge against losses in this investment sector.

APPENDIX to Statement by Professor Edward I. Altman

INTRODUCTION

Rising interest rates and rapid expansion of the high yield corporate debt market since the late 1970s have led a wide variety of financial institutions to explore the relative attractions of lower-rated securities. In addition to the promised superior yields and realized impressive returns, the high yield (or "junk") sector now offers considerable liquidity and diversification potential. It has been estimated that total outstanding debt in this area was over $80 billion by mid-1985. The segment analyzed in this study, all low rated, public, non-convertible debt, grew from under $10 billion in 1978 to almost $42 billion in 1984 and was over $50 billion by mid-1985. Estimates from individuals dealing in these markets indicate that an additional 15%-20% of the $50 billion rated debt can be found in non-rated, high yield securities. By 1984, the low-rated segment represented at least 11.2% of the total corporate, straight debt market, versus just 3.8% in 1978. In 1984 alone, nearly $15 billion in new straight, high yield financing was issued and in the first six months of 1985, an additional $8.0 billion have come to market (including exchange offers). Given the market's size, growth rate, yield, and capital raising potential, it has become an increasingly important area for investors and the investment banking community.

MARKET ANATOMY

Size, Growth and Returns

The 1978 to 1984 period was an exceptionally volatile period for interest rates and corporate profitability. Interest rates on three month T-bills and on 10 year government bonds rose from 7.4% and 8.4% yield levels respectively in early 1978, to record heights, peaking in mid-1981 at 17.2% and 15.3% respectively. By the fourth quarter of 1982, T-bills had dropped to 8% while 10 year governments were near the 10.5% level. At the same time, corporate profits plummeted in the 1981-1982 recession and bankruptcies reached record post-depression levels. Despite the overall economy's expansion in 1983-1985, the number of business failures and corporate distress situations has remained at historically high levels.

This volatility caused large variations in bond returns and yields over the period. Investment managers holding a portfolio equivalent to the Shearson Lehman Long-Term Government Bond Index would have experienced losses or marginally positive returns for all but two (1982 and 1984) years of the seven-year period from 1978 through 1984 (see Table 1). In effect, rising interest rates caused substantial reductions in the market value of their holdings, more than offsetting the coupon income these bonds generated. The decline in rates in 1982 and 1984 saved investors in long-term government bonds from having a negative return over the entire period.

With high quality bond returns fluctuating at or below zero returns from 1978 through 1981, portfolio managers began looking for new opportunities to boost their returns. High yield bonds from 1978 to 1981 returned an average of 4.4%[1] on investment while long-term government bonds returned an average of −1.1%. The high yield bond marketplace became an increasingly attractive option.

Based on data from the Morgan Stanley database, we found that portfolio managers investing in high yield bonds from 12/31/1977 to 12/31/1983 would have realized a compounded return of 11.45% versus 5.62% for long-term government bonds, a 583 basis point difference annually![2] That differential narrowed to 330 basis points by the end of 1984. The arithmetic average annual return spread was 3.70% or 370 basis points at the end of 1984 vs. 5.37% or 537 base points at the end of 1983. The average yield spread between high yield bonds and long-term governments over the same time frame (measured annually at the beginning of each year) was 364 basis points through 1983 and 367 basis points through 1984. Selected annual returns and yields are displayed in Exhibit 1. Thus the average yield spread (ex-ante) and average return spread (ex-post) from 1978-1984 were actually quite similar (3.57% vs. 3.70%) but there is very little similarity for each specific year.

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[1] The high yield portfolio results come from the Morgan Stanley database.

[2] Returns are very sensitive to the time period examined. For example, the return spread for the period 3/31/1978 to 3/31/1981 was 490 basis points. A three month shift causes a 90 basis point change in returns.

Table 1

Annual Returns, Yields and Spreads on Long-Term Government Bonds and High Yield (HY) Bonds

(Calendar Years)

	Return			Promised Yield[3]		
Year	HY[1] Return	LT Govt[2] Return	HY Return Spread	HY	LT Govt	Spread
1978	7.57%	−1.11%	8.68%	10.92%	8.11%	2.81%
1979	3.69	−0.86	4.55	12.07	9.13	2.94
1980	−1.00	−2.96	1.96	13.46	10.23	3.23
1981	7.56	0.48	7.08	15.97	12.08	3.89
1982	32.45	42.08	−9.63	17.84	13.86	3.98
1983	21.80	2.23	19.57	15.74	10.70	5.04
1984	8.50[4]	14.82	−6.32	14.97	11.87	3.10
Arithmetic Average:						
1978-1983	12.01	6.64	5.37	14.32	10.68	3.64
1978-1984	11.51	7.81	3.70	14.42	10.85	3.57
Compounded Average:						
1978-1983	11.45	5.62	5.83			
1978-1984	11.02	6.89	3.30			

[1] Morgan Stanley composite generated from over 440 high yield issues. Actual portfolios ranged in size from 153 in 1978 to 339 issues in 1983. This data base goes through 2/31/84.

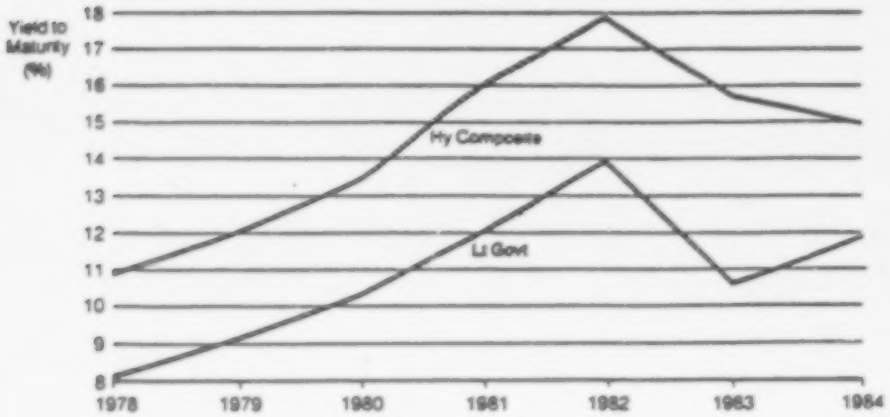
[2] Shearson Lehman Long Term Government Bond Index.

[3] Promised yield as of beginning of year. It represents the internal rate of return based on the security's current price and scheduled payments of interest and principal.

[4] Drexel Burnham Lambert Index from High Yield Newsletter (February 1985). Note this index does not include reinvested coupon payments and differs somewhat from the 1978-1983 measures.

Exhibit 1

Calendar Year Yields At the Beginning of Each Year



Calendar Year Returns 1978 Through 1984

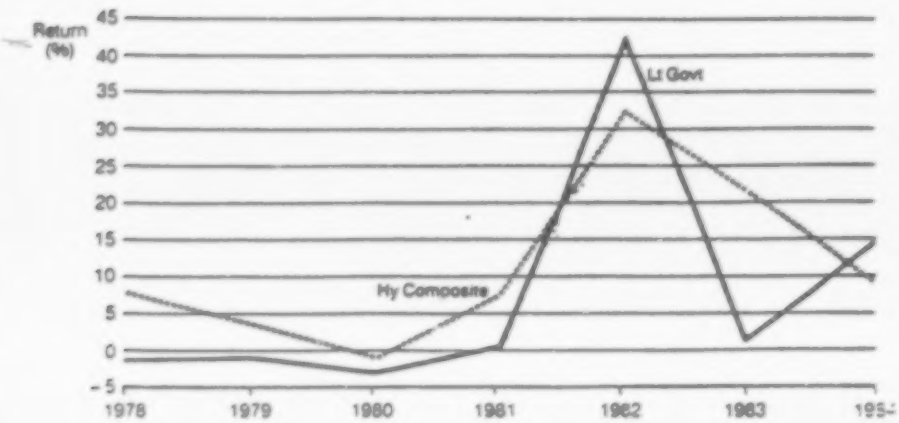
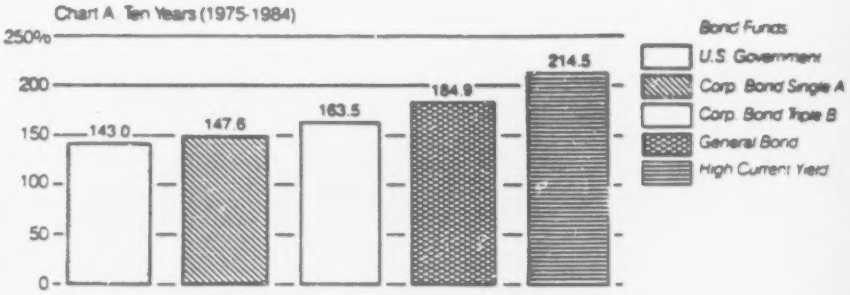
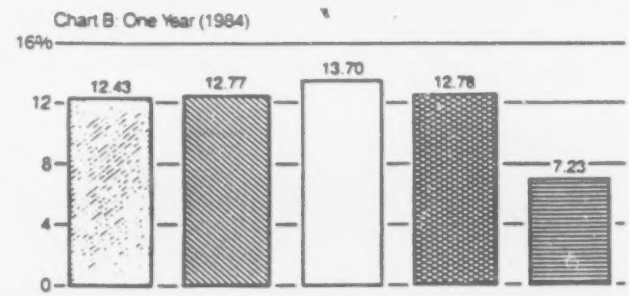


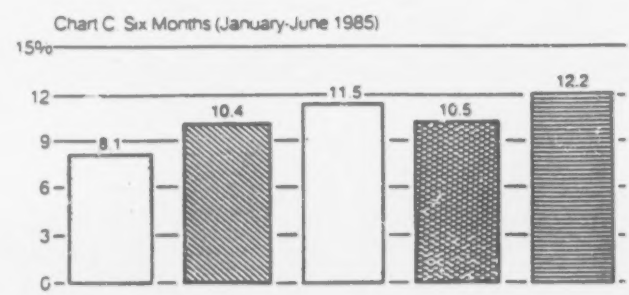
Exhibit 2 indicates the fixed income mutual bond fund performance of a number of strategies over the period 1975-1984, for 1984 alone, and for the first six months of 1985. These statistics were compiled by Lipper Analytical Services, Inc. and represent the average reinvested return performance of a number of funds investing in each category. Note that the return performance for the 10-year period is consistent with perceived risk attributes. The highest yielding funds were those of the High Current Yield category followed by General Bonds, Triple-B, Single-A, and U.S. Governments categories. Our own database calculations for the period April 1978-April 1984 show the same relative rankings as the Lipper rankings. This relative performance record also holds true approximately for the first six months of 1985, but not for 1984. In 1984, high yield bonds recorded only a 7.23% return compared to over 12% for all other fixed income categories. Whether or not the 1984 results are a one year aberration in the expected return spreads between different fixed income strategies, only time will tell. We believe, however, that the risk-reward tradeoff among different quality issues will in all likelihood be reflected in actual returns over the long run.

Exhibit 2

Selected Groups of Long-Term Taxable Bond Funds Total Reinvested Return for Selected Time Periods







Source: Lipper Analytical Services, Inc.

Exhibit 3

Monthly Returns for HY Composite

3/31/78 to 3/31/84

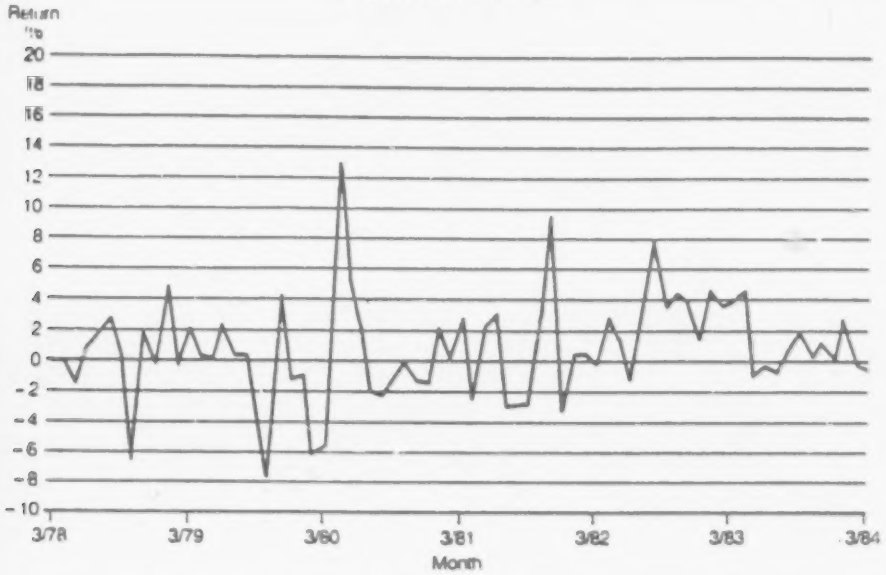


Exhibit 3 presents the *monthly* index of returns for our composite of high yield bonds. Monthly returns varied from a high of 13.13% in April 1980 to a low of −7.61% in October 1979. The average over the entire period 3/31/78-3/31/84 was 0.92% per month. Long-term government bonds had their highs and lows in the same months as the high yield bonds and averaged 0.52% per month over the same period.[3] Premiums like these are a major reason that demand in the high yield market expanded so rapidly.

Table 2 shows how quickly the market has changed. In 1978 the par value of public, low-rated straight debt outstanding represented 3.8% of the total public straight debt outstanding. By 1984 low-rated debt had grown to over 11%. Total public, straight debt outstanding grew 51% from 1978 to 1984. High yield, rated public debt more than quadrupled; from $9.4 billion to almost $42 billion. At the same time, the amount of debt per company and per issue grew substantially. The debt per company moved from $50 million to $125 million and the average outstanding per issue grew from $30 million to nearly $50 million in just six years.

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[3] We compared our monthly return results to those of M. Blume & D. Keim, "Risk and Return Characteristics of Lower Grade Bonds," Working Paper, Rodney White Center for Financial Research, The Wharton School, Phila. Pa. (1984) and Drexel Burnham & Lambert's (DBL 100 index) and found all three highly correlated ($R = 0.92$ or higher). These comparisons will be discussed in greater depth in our subsequent study.

Table 2

Public Straight Debt Outstanding 1970-1984

($MM)

Year	Par Value Public Straight Debt Outstanding Over Year[1]	Low Rated Debt[2] Straight Public Debt	% of Public St. Debt	Amount Outstanding Per Issuer	Amount Outstanding Per Issue
1984	$371,100(Est.)	$41,700	11.2%	$125	$49
1983	339,850	28,223	8.3	93	39
1982	320,850	18,536	5.8	69	33
1981	303,800	17,362	5.7	62	32
1980	282,000	15,125	5.4	59	31
1979	260,600	10,675	4.1	47	30
1978	245,000	9,401	3.8	49	30
1977	228,500	8,479	3.7	46	27
1976	209,900	8,015	3.8	41	27
1975	187,900	7,720	4.1	41	27
1974	167,000[3]	11,101[4]	6.6	59	35
1973	154,800	8,082	5.2	45	29
1972	145,700	7,106	4.9	45	29
1971	132,500	6,643	5.0	45	29
1970	116,200	6,996	6.0	48	32

[1] Average of beginning and ending years figures (1975-1984)

[2] Source: *Standard & Poor's Bond Guide* and *Moody's Bond Record*. July issues of each year. Data also reflects stock, too. Also includes non-rated and equivalent to rated debt for low rated firms.

[3] Estimates for 1973 and earlier based on linear regression of this column vs. the Federal Reserve's Corporate Bonds Outstanding figures (*Federal Reserve Bulletin*)

[4] Includes $2.7 billion in Con Edison debt

New Issues

The new issue public, straight debt marketplace (see Table 3) has grown phenomenally, moving from the $1.5 billion level in 1978 to just under $15 billion in 1984 (with a 100% increase between 1983 and 1984).[4] The high yield marketplace represented 15% of 1984's new, straight corporate debt issues and is expected to continue growing. New issue business in 1984 alone accounted for over 48% of the new issue business in the high yield marketplace since 1978 with a record number of issues with $200 million (par value) or more. The number of deals $100 million or larger rose from 2 in 1978, to 23 in 1983 and finally to 58 in 1984 (representing over 46% of the issues done in 1984, up from 27% in 1983).[5]

Since 1978 there have been 21 CCC rated, 256 B rated, 96 BB rated and 13 BBB/Ba rated new issues. The B and CCC rated issues accounted for over 62% of the high yield debt issues and 53% of the new, high yield issue dollars in 1984.

The average issue size has changed over the years, from $28 million in 1978 to over $120 million in 1984 (see Table 5). The median issue in 1984 was $77 million. This year saw both record size issues (i.e., Metromedia - $1.3 billion raised using a complex combination of four types of securities) and a record number of offerings (124, up by 44% over the prior year).

The average "years to maturity" of new issues dropped as interest rates increased. In 1978, the average life was 19 years (ignoring sinking funds). By 1984 it had fallen to 12 years. The average "duration" of bonds in our high yield universe was 6.45 years in 1983, down from 7.87 years in 1978, and has averaged 6.64 years over the 6-year period. By contrast, the average duration of Shearson Lehman's Long-Term Government Bond index over the same period was 8.53 years. See Table 4 for yield and duration attributes of various portfolios. In 1984 and 1985, despite interest rates moving in a downward trend, issuers have continued to shorten the years to maturity and duration on their debt.

The S&P rating distribution of new issues in recent years has been skewed toward single-B. In 1984 the number of single-B rated issues exceeded double-B rated issues by threefold.

[4] Excluding exchange offers, best effort offerings or convertibles.

[5] Source: High yield, new issues database—Morgan Stanley & Co. Incorporated.

Table 3

New Non-Convertible Domestic Debt Issues: 1978-1984[a]

($MM)

	Total New Issues–Public Straight Debt		High Yield Debt					
			Total New High Yield Debt Issues[b]		% New Issue Dollars	Issued with Warrants or Stock	Variable Rate Debt	
Year	Amount	No.	Amount	No.			Amount	No.
1984	$ 99,416	721	$14,952	124	15.0%	18	$3,927	27
1983	46,903	511	7,417	86	15.8	35	—	—
1982	47,798	513	2,798	48	5.9	10	40	1
1981	41,651	357	1,648	32	4.0	6	104	2
1980	37,272	398	1,442	43	3.9	8	137	4
1979	25,678	277	1,307	45	5.0	14	—	—
1978	22,416	287	1,493	52	6.7	15	—	—
Total	$321,134	3,064	$31,057	430			$4,208	34

[a] Source: Morgan Stanley & Co. Incorporated

[b] Issues excluding exchange offers, like exchange convertibles or government agencies.

Table 4

Yield and Duration Comparison on Fixed Income Portfolios[1]

Portfolio	1978	1979	1960	1981	1982	1983	Average
High Yield Composite							
Yield %:	10.71	11.52	16.16	15.90	18.62	13.77	14.45
Duration Yrs:	7.87	7.52	6.25	6.12	5.63	6.45	6.64
No. of Bonds:	153	203	243	280	286	339	
Shearson Lehman Long Term Govt Bond Index							
Yield %:	8.38	9.13	12.48	12.77	13.70	10.85	11.22
Duration Yrs:	9.90	9.55	8.04	7.84	7.44	8.44	8.53
Portfolio by S&P Rating							
BB Rated Portfolio							
Yield %:	9.80	10.85	14.99	15.12	17.21	13.07	13.51
Duration Yrs:	8.70	7.77	6.57	6.62	5.87	6.39	6.99
No. of Bonds:	34	51	61	49	55	70	
B Rated Portfolio							
Yield %:	10.83	11.79	16.73	15.96	18.50	14.20	14.67
Duration Yrs:	7.84	7.67	6.23	6.17	5.57	6.27	6.63
No. of Bonds:	60	93	114	137	143	150	
CCC Rated Portfolio							
Yield %:	12.86	13.38	17.89	17.91	22.70	15.60	16.72
Duration Yrs:	7.16	6.87	5.83	5.63	4.80	5.82	6.02
No. of Bonds:	17	14	16	33	21	35	

[1] Yields and duration are from 3/31 of each year and are weighted by the amounts outstanding.

Default Experience on High Yield Debt [6]

High yield bond investors in the past have experienced healthy return premiums over investment grade securities, but they have also experienced substantial defaults. Without a reliable measure of past losses from defaults, investors cannot intelligently estimate the net returns over time on high yield bonds.

Default rates can be measured using several different base levels or denominators (i.e., total public debt, total straight debt, low-rated debt, etc.). The default rates discussed here were derived by dividing the par value of defaulting debt by the total low-rated, straight debt outstanding. We found that the default rate on high yield bonds from 1974 to 1984 averaged 1.60% (or 160 basis points annually). Table 5 illustrates the annual default rates from 1970-1984. The default rate was 1.52% if Johns Manville's debt, the only issues rated investment grade just prior to default, is excluded. Year-to-year variations in this rate were substantial. This default level is significantly higher than rates generated using total straight debt outstanding as the base, i.e., .08 of 1% for the same period. We feel the higher rate is much more relevant to investors with portfolios in the high yield area since virtually all defaults occur in the low-rated segment of the corporate debt market.

The *actual losses* from default, however, are somewhat lower than these rates would imply. Defaulted bonds, far from becoming valueless, traded, on average, at 41% of par shortly after default. After accounting for the bonds' retained value and the loss of interest, the average reduction in returns to the investor would have been approximately 100 basis points annually, assuming purchase at par. As noted earlier, the recent (1978-1983) *net* returns on high yield debt have been very impressive.

Prior Bond Ratings

Table 6 lists the original issue ratings of straight and convertible bonds which subsequently defaulted. While only 8.0% (9 of 112 issues) of the defaulting bonds were originally rated A or better, a total of 34 (over 30%) were originally rated investment grade. These "broken, fallen angels" demonstrate that firms can deteriorate from solid credits into bankruptcy or default at a later date. The largest percentage (36%) of defaulting bonds were originally rated B.

While it is of some interest to examine the original rating of defaulting bonds, it is perhaps more relevant to assess the bond ratings as default approached. Rather than riding a bond all the way down, the portfolio manager can usually sell the security when its rating drops below some threshold level. In Table 6 we also examine defaulting bond ratings *12 months* and *six months* prior to reaching default status. The average rating is, as expected, lower than the original issue rating. We observed that 13 of 130 (10.0%) were rated investment grade (BBB-/Baa3 or above) one year prior to default and 4 of 130 (3.0%) just six months prior to default. The percents for straight debt only were 16.1% and 4.4% respectively. Finally, only Manville's debt was investment grade *one month* prior to filing. In summary, virtually all of the recent bond issue defaults were in the speculative or high yield (junk) categories just prior to default.

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6 This section summarizes an earlier study by the authors, "The Default Rate Experience on High Yield Corporate Debt," Morgan Stanley & Co. Incorporated, March 1985.

Table 5

Historical Default Rates–Low Rated, Straight Debt Only[1]

($MM)

Year	Par Value Outstanding with Utilities[2]	Par Value Defaulted	Default Rate	Par Value Public Outstanding Less Utilities[2]	Default Rate
1984	$41,700	$344.16	0.825%	32,120	1.071%
1983	28,233	301.08	1.066	22,167	1.358
1982	18,536	752.34	4.059[3]	16,111	4.670
1981	17,362	27.00	0.155	15,010	.180
1980	15,126	224.11	1.482	12,807	1.750
1979	10,675	20.00	0.187	10,031	.199
1978	9,401	118.90	1.265	8,995	1.322
1977	8,479	380.57	4.488	7,548	5.042
1976	8,015	29.51	0.368	7,024	.420
1975	7,720	204.10	2.644	6,971	2.928
1974	11,101[4]	122.82	1.106	7,445	1.650
1973	8,082	49.07	0.607	7,195	.682
1972	7,106	193.25	2.719	6,245	3.094
1971	6,643	82.00	1.234	5,935	1.382
1970	6,996	796.71	11.388	6,448	12.356
	Average Default Rate – 1970 to 1984:		2.240%		2.540%
	Average Default Rate – 1974 to 1984:		**1.604%**[3]		**1.872%**
	Average Default Rate – 1978 to 1984:		1.291%		1.507%

[1] Issues rated below Baa3 by Moody's or BBB- by Standard & Poor's. Includes non-rated debt of issuers with other equivalently rated issues

[2] Source: *Standard & Poor's Bond Guide* and *Moody's Bond Record*, July issues of each year

[3] Excluding Johns Manville, the default rate for 1982 was 3.115% and it was 1.518% for the 1974–1984 period

[4] Includes almost $2.7 billion of Consolidated Edison Co. debt

Table 6

Rating Distribution of Defaulting Issues at Various Points Prior to Default[1]

Original Rating

	AAA	AA	A	BBB	BB	B	CCC	CC	TOTAL
Number	0	2	7	25	21	40	17	0	112
Percentage	0%	1.8%	6.2%	22.3%	18.8%	35.7%	15.2%	0%	100%

Rating One Year Prior

	AAA	AA	A	BBB	BB	B	CCC	CC	TOTAL
Number	0	0	2	11	14	53	43	7	130
Percentage	0%	0%	1.5%	8.5%	10.8%	40.8%	33.1%	5.3%	100%

Rating 6 Months Prior

	AAA	AA	A	BBB	BB	B	CCC	CC	TOTAL
Number	0	0	2	2	10	51	53	12	130
Percentage	0%	0%	1.5%	1.5%	7.7%	39.2%	40.8%	9.2%	100%

[1] Includes convertibles and straight debt issues. Excludes railroad issues. Ratings from *Standard & Poor's Bond Guide*. Data from Bencivenga (1983) was also consulted.

CREDIT QUALITY OF HIGH YIELD DEBT

Measuring a Firm's Operating and Financial Risk

In our prior discussion on the anatomy of the high yield market, we documented the impressive increase in the number and size of new issues from 1978-84. A lurking question related to this increase concerns the credit quality of these new issues and the impact that increased competition amongst underwriters has had on the profile of new, high yield issuers. This section examines the overall trends of issuer credit quality in the market and looks at credit techniques to be used to identify and avoid credit deterioration. While the most "sensational" questions revolve around leveraged buyouts, hostile take-overs and defensive strategies (e.g., "greenmail") used by firms issuing debt securities, our study does not address these new phenomena directly.

Traditional financial statement analysis is basically a univariate approach whereby individual measures of firm performance, primarily ratios, are compared with other firms in the same sector or perhaps within a specific bond rating and also examined over time to assess trends in such performance categories as liquidity, profitability, cash flow, leverage and solvency, and asset turnover. While a pervasive tool amongst credit practitioners, traditional ratio analysis suffers from potential problems in ambiguity, subjectivity, and misleading numbers. Essentially, there is no "bottom line" as to firm performance and risk attributes. Hence, the final determination is a subjective product of the individual observing the ratios. Since our goal is to assess the credit quality of hundreds of firms in the high yield market and to compare aggregate measures with investment grade securities over time, we need an objective approach which is capable of summarizing a number of disparate operating and financial characteristics into a single, unambiguous measure. We have chosen Zeta™ credit evaluation scores, to assess credit quality in our high yield firm universe. Zeta was developed by Altman, Haldeman and Narayanan (*Journal of Banking and Finance*, June 1977) to identify the bankruptcy risk of industrial corporations. Building upon earlier bankruptcy classification works, Zeta combines traditional financial measures with a multivariate technique known as discriminant analysis so as to lead to an overall "credit-score" for each of the firms being examined. This model is of the form:

$$\text{Zeta} = a_0 + a_1X_1 + a_2X_2 + a_3X_3 \ldots\ldots a_nX_n$$

where Zeta = Overall credit score

$X_1 - X_n$ = Explanatory variables (ratios and market measures)

$a_1 - a_n$ = Weightings or Coefficients

The explanatory variables include measures of a firm's profitability, stability of earnings, debt service capability, cumulative profitability, liquidity, capitalization and size. The lower the firm's Zeta score, the more "in-distress" the model reports for the firm. Negative Zetas do not indicate default or bankruptcy with certainty but the lower the score, the greater the similarity between that particular firm and those which have gone bankrupt in the past. The average Zeta score for past bankrupts was about −4.0 in the original sample and −5.0 for those filing subsequent to the model's construction.

Credit Quality of Individual Issuers

We have investigated the credit quality and risk identification questions from several dimensions. The primary assessment tool used is the Zeta credit risk model. We also examined the trends of numerous traditional ratio measures of performance but found it difficult to summarize credit

quality from a large number of sometimes disparate results. Hence, the unambiguous, composite statistic of Zeta was utilized to assess:

- The trend in Zeta of new issuer, high yield straight debt securities over time and relative to the absolute levels and trends of existing bonds in the different bond rating categories.
- The default predictive qualities of Zeta with particular emphasis on the securities in the Morgan Stanley database.

New Issuer Credit Quality

New issue, high yield securities appear to have experienced an upward (better quality) trend over the last half-dozen years (with the exception of 1983). Table 7 lists the median and average Zeta scores of new issuer firms.[7] In 1978, the central tendency of new issuer scores was roughly equivalent or slightly above the average S&P single-B rated debt. Note that the high yield new issuer's score increased from a −1.05 median in 1978 to −0.65 in 1980. But, we did observe that the trend was also favorable for all single-B rated debt in that three-year period. Indeed, the median or average high yield new issuer score was just about the same (−0.65) as all S&P single-B rated debt (−0.52) in 1980.

The divergence between the trend in new issuer, high yield debt and the entire debt market started to take place in 1981 and has continued to the present. Exhibits 4 and 5 clearly illustrate these differences. The Zeta trend in new issuer debt rated BB/B continued to improve in the 1981-1984 period (except 1983), especially the median score, while the overall BB/B market deteriorated in the face of the recession. This deterioration has continued in the most recent expansionary years. No doubt, a number of deteriorating higher grade securities, the so-called "fallen angels," helped to contribute to this decline. The trend in investment grade debt rated BBB and A was only slightly negative over this most recent period and was essentially unchanged from 1978-1984.

Table 7

High Yield New Issuer Zeta Scores 1978–1984

(Straight Debt Only)[1]

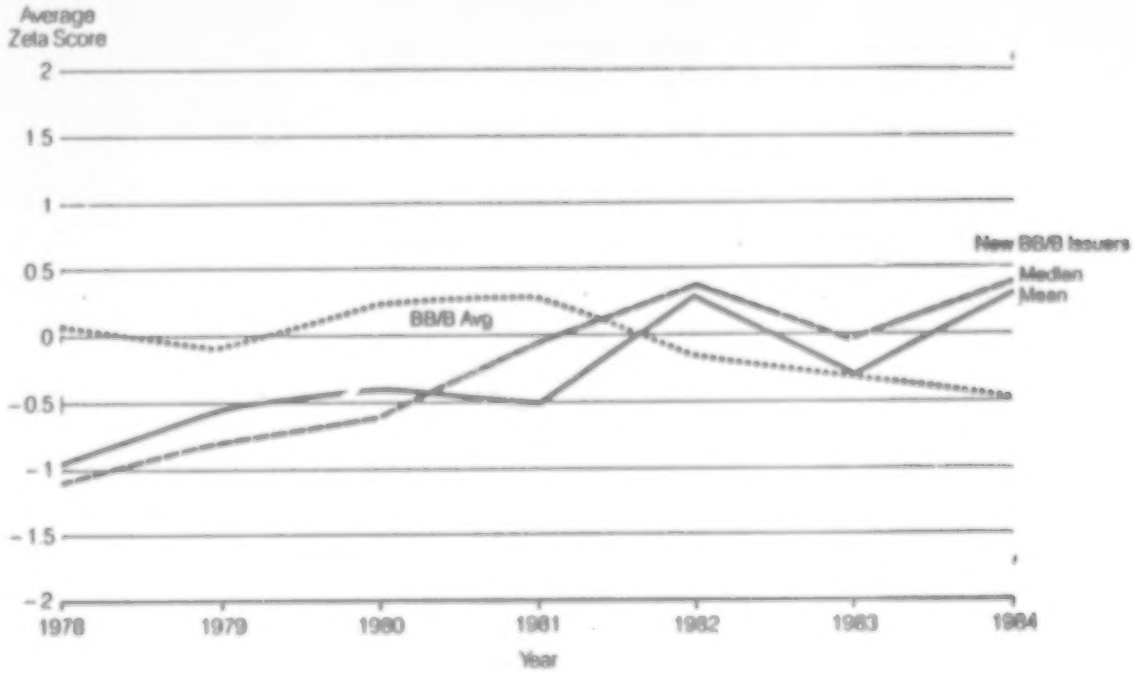
Year	Number of New Issues	Number of Companies With Zeta Scores	Median Zeta	Average Zeta
1978	52	27	−1.05	−0.96
1979	45	33	−0.84	−0.54
1980	43	24	−0.65	−0.40
1981	32	15	−0.03	−0.52
1982	48	20	0.30	0.29
1983	86	46	−0.15	−0.30
1984	124	53	0.35	0.31

[1] Does not include convertible or exchange offers.

[7] Zeta scores are from the financial statement closest to the new issue date. Medians were actually higher, on average, as of the end of the year of issuance. It must be stated that we could not find Zeta scores for all new issuers. For instance, in 1983 and 1984, we found Zeta for 65% and 59% of new issuers, respectively. The average percentage of new issuers for which Zeta scores were available over the seven-year period was 61%. Since the "not available" category was more than likely comprised smaller firms and perhaps lower Zeta scores, our results are somewhat biased—but, the bias is a conservative one.

Exhibit 4

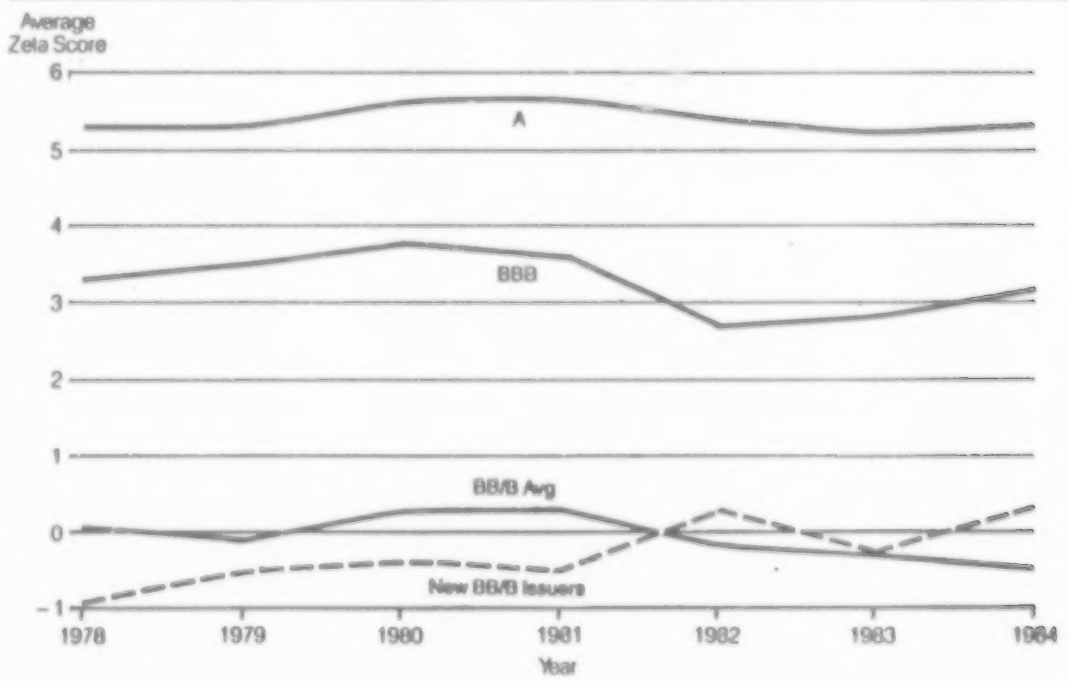
Zeta Scores: New vs Existing Issuers Rated BB/B by S&P



Source: Zeta Scores of existing and new issuers from Zeta Services, Inc.

Exhibit 5

Zeta Scores: New vs Existing Issuers
By S&P Rating (From Zeta Services, Inc.)



While the overall credit profile of new issuer, high yield debt is still in the risky zone, around a Zeta of zero, we have observed an overall improvement in this group both in absolute and relative terms. This does not mean that the credit analyst or risk arbitrageur can relax, since the distribution of scores is quite wide with several new issues fairly deep in the negative Zeta zone (7 of 46 (15%) had Zetas −3.0 or below in 1983 and 7 of 53 (13%) in 1984). Still, if one had to assess the average quality of the new issue, high yield marketplace, the conclusion would be a slight improvement over the 1978-84 period.

Default Risk Assessment

Zeta scores correctly identified Chapter X and XI (now Chapter 11) bankruptcies 95% of the time based on data from one statement prior, over the post-model development period 1977-82. The accuracy rate is probably lower if we include the most recent data since firms like Johns Manville, Revere Copper & Brass and Storage Technology were not identified correctly. A more relevant examination for this study is to assess the ability of Zeta to "red- flag" defaulting companies with publicly traded, straight debt securities.

The Morgan Stanley High Yield Data Base contained 20 issuer defaults involving 30 different straight debt issues. These firms are listed in Table 8 with their Zeta scores one and two statements prior to default. The results indicate that all but two of the defaults could have been avoided with a strategy of not including (or selling) a firm's debt when its Zeta score was below zero. The number drops to just one firm (Storage Technology) using a strategy of holding only issues with Zeta scores greater than 1.0. And, if an investment grade triple-B equivalent Zeta score (approximately 2.5) is adhered to, every default would have been avoided. There were just four firms with positive Zetas two financial statements prior, and just three with Zeta scores above 1.0.

In summary, a fundamental credit approach like Zeta can probably eliminate most of the default risk in a dynamic, actively managed portfolio. It can certainly be argued that other credit evaluation tools can also successfully reduce default risk. The earlier the credit system detects impending defaults, the smaller the realized credit deterioration and principal loss will be for the portfolio. The average price deterioration on defaulting issues, prior to default, was mentioned in the Default Experience section of this report.

Table 8

High Yield Defaults and Prior Zeta Scores

(Data Base Firms Only)

Company	Default Date	Zeta One Statement Prior to Default	Zeta Two Statements Prior to Default
AM International	4/82	-4.60	-0.18
Altec Corp.	9/83	-9.28	-7.88
Amarex Corp.	12/82	-1.61	-1.25
Anglo Company	11/83	-0.15	1.20
Braniff (4 Issues)	5/82	-5.37	-3.40
Charter Co. (2 Issues)	4/84	0.77	1.40
Emons Industries	4/84	-4.30	-4.99
Food Fair (2 Issues)	10/78	-0.61	-0.68
Gamble Skogmo	4/82	-3.20	-1.58
Grolier (2 Issues)	7/77	-8.95	-1.73
Hardwicke Corp.	7/83	-10.10	-4.61
Lionel Corp.	2/82	-1.61	-1.91
MGF Oil	5/83	-4.19	-2.42
Mego Int'l	3/82	-7.46	-0.36
Morton Shoes	1/82	-5.05	-2.72
Storage Technology	11/84	1.63	3.13
Telcom Corp.	12/82	-4.72	-2.75
Texas Int'l Air	9/83	-4.11	-4.26
United M&M	7/77	-0.38	0.24
Wickes Co. (5 Issues)	4/82	-3.85	-1.17
Average Zeta Score		-3.85	-1.79

THE TYPICAL NEW ISSUER IN 1983 AND 1984

Age, Size and Rating

In 1984, the "typical" new, straight debt issuer in the high yield market was a 26 year-old firm with $735 million in assets earning 2.7% after taxes on those assets. The new issue was for $77 million, yielding 15.4% and paying a 14.5% coupon; the issue received a single-B rating from Standard & Poor's. The firm's credit rating was relatively good compared to other single-B rated issues with a median Zeta score of 0.35 vs. −2.06 for B-rated bonds.

In 1983, our "typical" issuer was a 20 year-old firm with $322 million in assets and the same 2.7% return on assets. The new issue was $60 million in size, yielding 14%, with a coupon of 12% and received a single-B rating from Standard & Poor's. The median Zeta credit rating was lower at −0.03 but still above the average single-B rated company.

These are the results of an in-depth profile analysis of new issues over the last two years. The generalized profile is based on median issue and issuer characteristics summarized in Table 9. This data is based on 124 new issues (99 issuers) in 1984 compared to 86 issues and 68 firms in 1983. We also report the mean results for the aforementioned categories and note a fairly large standard deviation for most of them. Observation of frequency distributions of new issuers age and size revealed the following:

- In 1984, 26% of the firms were relatively young (less than 15 years in business). A rather large proportion, over 50%, however, were seasoned firms, in business over 25 years. This compares to 43% for 1978-79 new issuers. This might be the result of more aggressive underwriting efforts and buyouts, as well as the robustness of the market. Surprisingly, the median age of new issuers in 1983-84 is only slightly above the 1978-79 median (23 vs. 19).
- Firm size was impressive with over 26% of the firms having assets over one billion dollars compared to 21% in 1983. Median total assets of new issuers in 1983-84 ($322 and $735 million) is, as expected, considerably higher than the earlier 1978-79 medians ($107 and $127 million). No longer is the new issue market the primary province of the small, unseasoned company.

CONCLUSION

This paper has concentrated on presenting a generalized description of the high yield debt market. We have specifically not included analysis of individual firms and have laid the foundations, we hope, for a more in-depth analysis of specific investments and portfolio strategies.

Table 9

Profile of New Issues
High Yield Straight Debt Market

(1983 and 1984)

Issue Characteristics

	Average				Median				Standard Deviation			
	1978	1979	1983	1984	1978	1979	1983	1984	1978	1979	1983	1984
Size of Issue ($ Millions)	28.7	29.0	86.2	120.6	25.0	20.0	60.0	77.5	19.6	21.3	123.7	150.6
Coupon Rate (%)	—	12.3	12.0	13.3	—	12.3	11.8	14.5	1.0	1.1	1.8	3.9
Yield to Maturity (%)	—	12.6	14.0	15.2	—	12.6	13.8	15.4	1.1	1.2	1.3	1.4
S&P Rating	B/B+	B/B+	B/B+	B/B+	B	B	B	B	—	—	—	—
Number of Issues	52	41	86	124								

Firm Characteristics

	Average				Median				Standard Deviation			
	1978	1979	1983	1984	1978	1979	1983	1984	1978	1979	1983	1984
Age of Firm (Years)	22.8	26.0	28.2	31.1	18.0	20.0	20.1	26.0	14.7	19.6	22.4	23.1
Asset Size ($ Millions)	176	285	1,074	1,588	107	127	322	735	187	487	1,776	2,435
Return on Assets (%)	—	—	1.5	1.9	—	—	2.7	2.7	—	—	7.8	8.2
Zeta Score (Issues)	-0.89	-0.76	-0.16 (52)	0.74 (65)	-1.15	-0.84	-0.30	0.78	1.7	1.3	3.4	3.3
Zeta Score (Firms)	-0.96 (28)	-0.54 (31)	-0.30 (46)	0.31 (53)	-1.05	-0.84	-0.03	0.35	1.5	1.2	3.0	3.1
Number of Firms	50	40	68	99								

Chairman HUBBARD. Thank you, Dr. Altman. We appreciate your testimony, as we do the testimony of the others. We now have some questions.

Would a 10-minute limit be agreeable to each of us?

First to Julie Williams. During your testimony today, Julie, you refer continually to the high-yield bonds that are issued in corporate takeovers. Yet, industry witnesses have stated over and over that these types of bonds are not that widespread or used by federally insured institutions.

Is it this type of junk bond that is particularly worrisome to the Federal Home Loan Bank Board?

Ms. WILLIAMS. The information that we have available to us now indicates that the involvement of thrift institutions in acquisitions of that type of low-grade bond is not that extensive. What it does raise is the policy question that I referred to in my opening remarks and that is discussed in more detail in my written statement, namely the extent to which federally insured institutions should be players in the corporate takeover arena. They don't seem to have been extensively involved so far.

What we need to look at, and our basic concern in the first category as far as what the Bank Board is thinking of in a regulatory approach for corporate debt securities, is the overall risk that is presented by any type of corporate debt security.

So the problems or the things that we think that insured institutions should be looking at would not be isolated to purchases by insured institutions of these bonds that are used to finance corporate takeovers.

Chairman HUBBARD. Thank you. On page 13 of your testimony, you discuss the recently adopted direct investment regulation of the Federal Home Loan Bank Board. You state that the rule "requires a special review by the Board's supervisory staff when the amount of an institution's direct investments in real estate and certain equities exceed certain levels. When proposed increased direct investments present safety and soundness concerns, they may be disapproved."

My question is, Has the Bank Board had the occasion to take disapproval regulatory measures with any institutions?

Ms. WILLIAMS. My understanding is that the supervisory staff at the various Federal home loan banks has disapproved certain direct investments. I personally don't have more specific information on that.

Chairman HUBBARD. Can you tell us when your study of further regulatory proposals will be completed and made available?

Ms. WILLIAMS. With respect to the corporate debt security issue?

Chairman HUBBARD. Yes.

Ms. WILLIAMS. The staff is working very actively on that and has reviewed a number of options. I can't speak for our Bank Board, but I think that it's an area where the Board does have concerns and does want to be involved. Addressing the corporate debt security issue follows naturally from the direct investment regulation, which addresses the investment by insured institution in equity investments.

So we expect to get there very shortly, I would think.

Chairman HUBBARD. Julie, are there statistics which show the percentages of high-yield securities issues for hostile takeover purposes versus those issued by growing businesses?

Ms. WILLIAMS. I'm not aware of those statistics, but perhaps other members of the panel would be able to speak to that, and would have more specific information.

Chairman HUBBARD. Could there be a possibility that the Bank Board might gather this information?

Ms. WILLIAMS. Let me add, we have, and I referred to this in my statement, the Bank Board has conducted a sample survey last March which produced the statistics that you have today. We also have instituted some changes in the reports that insured institutions are required to file with the Bank Board and now there's a new line item that is designed to capture investments in what would be referred to as junk bonds.

The information was first reported for the close of June. We have the data, but it has not been analyzed. I can't speak to whether there would be a breakdown in that information according to the lines that you mentioned, but if there is, I'm sure that we can provide that to you.

Chairman HUBBARD. Thank you. Please do for our record.

[In response to the request of Chairman Hubbard, the following information was submitted for the record by Ms. Williams:]

Federal Home Loan Bank Board

OFFICE OF POLICY AND ECONOMIC RESEARCH

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

May 7, 1985

MEMORANDUM FOR: FEDERAL HOME LOAN BANK BOARD

FROM : Eric I. Hemel
Director

Richard C. Pickering
Deputy Director

SUBJECT : Thrift Industry Holding of "Junk" Bonds

The following summarizes the result of a special survey of FSLIC-insured institutions conducted by the Federal Home Loan Banks at our request in order to provide an estimate of industry holdings of "junk" bonds on March 31, 1985. A sample of 352 institutions were surveyed, comprised of all institutions reporting holdings of non-Federal government/agency securities at yearend 1984 in excess of $70 million and a random sample of other institutions, with the sample subdivided into 3 strata. While the number of institutions in the sample was small, they accounted for nearly 70 percent of the industry's holdings of non-Federal government/agency securities. "Junk" bonds for purposes of the survey were defined as debt securities that are either not rated by a nationally recognized investment rating service or were rated by one or more such services as below investment grade. Except as noted below, the survey covered only "junk" bonds held by insured institutions, excluding those held by service corporations/subsidiaries, and only those classified as securities, even though the distinction between a loan and a security is not always clear-cut and the former, therefore, can be used to conceal "junk" bond holdings.

(1) FSLIC-insured institutions are estimated to have held $4.0 billion of "junk" bonds on March 31, 1985. This represented 0.4 percent of industry assets.

(2) Most "junk" bonds were held by a few large institutions. Ninety-five percent of the estimated total volume was held by the 200 institutions with the largest holdings of non-Federal government/agency securities (which were all included in the survey) and 79 percent by the 10 institutions with the largest "junk" bond holdings.

(3) About 23 percent of the 200 largest institutions reported holdings of "junk" bonds, but only an estimated 3 percent of the smaller institutions.

(4) Most "junk" bonds were held by associations in three FHLB Districts. Of the $3.8 billion held by the 200 largest institutions, 52 percent ($2.0 billion) was held by institutions with home offices in the San Francisco District; 24 percent ($0.9 billion) was held by institutions in the Dallas District and 18 percent ($0.7 billion) was held by institutions in the Atlanta District. (The sampling procedure used does not permit accurate allocation among Districts of the $0.2 billion estimated to be held by smaller institutions).

(5) While the survey covered only "junk" bonds held directly by insured institutions, San Francisco also inquired into holdings of "junk" bonds by subsidiaries. About $1.2 billion of such holdings were reported, with most of the dollar volume at one service corporation (this amount, of course, should be added to the aforementioned $4.0 billion estimate for direct holdings of insured institutions). In addition, the Pittsburgh District reported approximately $4 million of "junk" bonds holdings classified as commercial loans, rather than securities, by three institutions.

cc: S. Fairbanks
J. Gould
D. Boyle
J. Butler
F. Haas
B. S. Moore
N. Raiden
W. Schilling
P. Stearns
A. Withers
FHLB Presidents

Chairman HUBBARD. Before I begin questioning Chris Andersen of Drexel Burnham Lambert, I would invite Dick Pratt of Merrill Lynch to feel free to respond as he feels appropriate. This would also apply to Chris Andersen as I ask questions of Dick Pratt.

Chris, there continues to be a lot of controversy concerning the hostile takeover issue. There is little doubt but that a hostile takeover with the use of high-yield bonds could leave an issuer very highly leveraged.

Does your firm take this into account?

Mr. ANDERSEN. Absolutely.

Chairman HUBBARD. Does your firm believe that the taxpayer should shoulder the risk of having a federally insured institution invest in the junk bonds in a corporate takeover attempt?

Mr. ANDERSEN. My problem sir, is that I don't know what the word "hostile" means. I don't think I can answer the question without such a definition. I think "hostile" is a frame of mind of probably about five executives of the top of a large corporation until such point in time that they cease negotiating for the acquisition price.

Chairman HUBBARD. To ask it another way—should the American public be acting as guarantors for thrifts who want to engage in these activities?

Mr. ANDERSEN. I'm still not sure I can answer the question. I don't see how they're acting as guarantors if you have an adequately diversified portfolio anymore than they're acting as guarantors for somebody speculating in land some place, wherever.

The question here is not the guarantor. I think it is, rather, is this a legitimate, soundly structured investment and is the institution making it engaging in a sound investment practice?

I believe that by reviewing the transaction, you look at the soundness of the situation. I don't believe that the absolute level of debt in a capitalization at a given point in time has anything to do

particularly with whether or not that is absolutely on some defined scale a risky investment.

I believe there's much more money lost by people investing in Government securities with bad underwriting practices in the thrift industry than there are people engaged in leveraged buyouts and high-yield bonds in takeovers and everything else.

It's a matter of the financial practice; not a matter of the leverage.

Chairman HUBBARD. Would you care to add to what he has said, Dick Pratt, as to those questions?

Mr. PRATT. Not especially, but——

[Laughter.]

Mr. PRATT [continuing]. I think probably in a corporate sense we have not really sat down and asked ourselves those questions. And, in many respects, I think it probably is the responsibility of the Congress to decide what the public conscience should be and that investment houses and others then act within the rules of the game that are set up.

I think that most investment banking houses, as long as a transaction is considered ethical and legitimate and within regulatory structures, looks more to the financial soundness. And I'm not sure, as a matter of public policy, we should ask them to do more than that.

I don't know if that's responsive.

Chairman HUBBARD. Thank you. Back to Chris. On page 2 of your prepared testimony, you state Standard & Poor's and Moody's rating systems rely on "only partial indicators of future capability to service debt and which do not give sufficient weight to growth experienced by rapidly expanding companies."

What characteristics does Drexel look to when assigning its own ratings to issuers?

Mr. ANDERSEN. Management is the first and most important criterion The second most important criterion is probably cash flow, stability of cash flow, predictability of cash flow. Diversification of assets within the institution is probably third. And the liquidity and availability of good viable markets for any of those assets to adjust to whatever changes or shifts might come because of short-term vagaries of the economy that cannot be predicted at the time that the structure is put together.

Chairman HUBBARD. What about Drexel's track record thus far in picking successful issuers?

Mr. ANDERSEN. I think the reason that Drexel has risen from the 31st largest investment banking firm to the largest investment banking firm for corporate securities in the last 9 years is based entirely upon one fact—our clients make more money than the other firms' clients. And they make it by investing in the securities we underwrite.

I believe that record stands for itself.

Chairman HUBBARD. That was a good question for me to ask you, wasn't it? [Laughter.]

Mr. ANDERSEN. Thank you very much, sir. [Laughter.]

I wish we were on TV. [Laughter.]

Chairman HUBBARD. Sorry. We wish more could hear your views. Now we'd better go to Dick Pratt.

Your information presented today in your prepared statement concerns the safety of high-yield bonds. In this new era of high-yield bond financing, however, we have yet to experience a serious economic recession or downturn.

In short, high-yield bond financing has not been tested in troubled times.

Dick, how would you respond to this concern, and just how serious would the effect of a recession be on bond issuers and investors?

Mr. PRATT. In looking at our whole financial system, a basic concern is its vulnerability to what I would call nondiversifiable risk. And we certainly have seen that again in the farm sector and other areas. And I don't know that there is a very good answer to that. In a very substantial downturn, obviously American business is going to be in deep trouble. And if American business is in deep trouble, our national financial institutions are going to be in deep trouble.

I think we simply have to look at the lender of last resort, the liquidity of the national system, and so on in that regard.

At the same time, I think a policy of only restricting credit to the best well-established firms having the least risk would probably ensure a lower standard of living for the American people. Someone has to finance the new businesses. Someone has to finance the local businesses. Someone has to finance growth in America. And certainly, those are the businesses that are vulnerable in a widespread downturn.

I think it's a risk that simply ultimately falls to the lender of last resort and the ability of our national systems to hold together.

Chairman HUBBARD. On page 3 of your prepared testimony, Dick, you take great length to advise the subcommittee that some State laws are more liberal than the Federal law as to the investment and risk practices of their institutions.

Does Merrill Lynch believe that H.R. 1680, which would mandate the payment of supplementary premiums to the FSLIC in return for the right to engage in riskier investments, would be a workable solution to the Federal/State discrepancy?

Mr. PRATT. The firm has not taken a position on H.R. 1680. I could perhaps get a corporate response to that. Let me speak from my own position and not necessarily representing the views of the firm in that regard.

First let me say, I think junk bonds are not the problem, but the reform of the insurance corporations certainly is. And to the extent that that reform also needs to deal with different levels of risk, this is germane.

But legislation or regulation which would require more capital for what are perceived to be risky activities and which would bring other approaches of market discipline into the system I think would be appropiate and that we, in fact, do have a crisis in the Federal deposit insurance systems. I disagree with Chairman Volcker in that regard.

Chairman HUBBARD. Thank you. My time is up and I have not asked Dr. Altman any questions. But in fairness to the other members, I'm going to call next on Congressman Stan Parris.

Mr. PARRIS. Thank you very much, Mr. Chairman.

I am not at all disappointed in the quality of the testimony. I knew it was going to be good and I appreciate your thought-provoking comments this morning, ladies and gentlemen. I would just say to Mr. Andersen that a hostile takeover is when the price is too low, Mr. Andersen. That's what that is.

Mr. ANDERSEN. I've seen them priced both ways, unfortunately, sir.

Mr. PARRIS. That's right. I was struck with the consistency—I think there's a thread in the testimony of all of you, ladies and gentlemen. Mr. Pratt, for instance, talked about the correlation—I think it was Mr. Pratt—the correlation between risks of some real estate loans that are not sometimes what we would like them to be.

But it seems to me that there is a fundamental distinction which this subcommittee is attempting to shed some light on. Or at least direct the attention of some appropriate persons in our society to. And that is that the Federal Government does not, in fact, insure the soundness of a capital investment in risky real estate syndications.

On the other hand, as Ms. Williams has pointed out, in the real world, increasingly, we find that, ultimately, the Federal Savings and Loan Insurance Corporation shoulders, almost, if not entirely, the entire responsibility for State-chartered thrifts which are receiving more varying powers and an aggressive trend in some State legislatures, not the least of which, as we all know, is South Dakota. They are expanding the powers for State-chartered associations. And we are rapidly reaching the point where, as has been pointed out in Ms. Williams' testimony again, the fiscal consequences to the Federal insurance funds are totally divorced from the authorities being granted by the State legislatures.

Now that's a real risk, it seems to me, to the dual regulatory system. And that's one of the fundamental premises on which this hearing has been held this morning, I believe, and which we, as responsible legislators and as regulators, must ultimately address our attention.

Is that, in fact, a problem in our society? That's what this is all about, it seems to me.

Let me very quickly address just several questions. Ms. Williams, there have been some assisted liquidations, mergers, whatever, over the last several years. Could you share with us, are any of the institutions' problems traced or directly attributable, at least profoundly affected, by investments in high-yield securities and, if any, what cost they might represent to the funds?

Ms. WILLIAMS. Congressman, I think it would not be accurate to say that we could trace a particular failure to an institution's involvement in so-called junk bonds. However, and this relates directly to the comment you just made, we have suffered from them. The FSLIC will take some significant losses on junk bonds that were in the portfolio of Beverly Hills Savings & Loan. I don't think we know the specific amounts at this time. Beverly Hills, of course, was a California State-chartered institution.

Mr. PARRIS. Is this the California institution you referred to on page 4 of your formal testimony?

Ms. WILLIAMS. No, sir.

Mr. PARRIS. Is the "one California institution" which you say has $1 billion in securities rated less than BBB, is it on a troubled institution list?

Ms. WILLIAMS. Not to my knowledge, sir.

Mr. PARRIS. It's not currently rated?

Ms. WILLIAMS. I beg your pardon?

Mr. PARRIS. It's not currently rated as——

Ms. WILLIAMS. Not to my knowledge.

Mr. PARRIS. OK. You say in a portion of your testimony that 92 percent, which was the figure I used, as you may recall, in my opening statement, which impressed me, 92 percent of the $4 billion, but federally insured, and that's the critical criteria here, are State-chartered institutions.

Is there a reason why federally chartered institutions are avoiding high-yield securities?

Ms. WILLIAMS. Sir, it's hard to know specifically on the basis of the information that we have. Their investment powers, in general, are more limited than those that are available to some State-chartered institutions. And according to the percentages that we discovered in doing that survey that produced the $4 billion figure, the vast percentage of the amount can be traced to savings and loans that are located in certain States that are noted for having very liberal investment authorities—California, Texas, and Florida.

I can't really be more specific as far as explaining the Federal——

Mr. PARRIS. I understand. I don't mean to try to put you on the hot seat, Ms. Williams, and I'm not, but let's get right down dirty.

Is the CEO or some S&L, some place other than those three States, sitting at his desk saying, I don't want to get involved with high-yield bonds? I'm liable to get in trouble with the regulators.

Is that what they're saying in the real world?

Ms. WILLIAMS. I think that the Bank Board, through statements by our chairman, as well as a directive that has gone out to the supervisory staff, has made clear that institutions that are thinking of getting involved in the below investment-grade bond market had better do so only after having carefully considered the financial stability creditworthiness of the issuer of those bonds. And if the examiners find out in their examination process that there hasn't been a demonstrable effort to use prudent underwriting practices in getting into junk bond purchases, that will be cited on an examination report.

Mr. PARRIS. I'll interpret your answer as "yes." [Laughter.]

Ms. WILLIAMS. Fair enough. [Laughter.]

Mr. PARRIS. Thank you. Mr. Pratt, you made mention in your comments that there is an appropriate portfolio in high-risk securities. And I agree with that. I tried to make that observation in my opening statement.

Your Mr. Richard Omohundro, the manager of your firm's high-yield bond department, as I understand it, quoted in the June 26, 1984, New York Times article, in which he predicted, "There will be some spectacular disasters in the underwriting and trading of junk bonds where the buyers will be hurt."

As Ms. Williams has said, the Columbia S&L, Beverly Hills owns approximately today, I think, if this is correct, owns approximately $2 billion in high-yield bonds and has $6.1 billion in assets.

Would you care to comment or speculate as to whether FSLIC could afford a spectacular disaster involving an institution withholding similar to that one? I'm not asking you to predict their unfortunate demise. I'm saying if you take a hypothetical S&L with that situation, would that give you some cause for concern if you were still Chairman of the Federal Home Loan Bank Board?

Mr. PRATT. Spectacular disasters may have to take a number based on recent events in some of the markets. But, I think that we're back to the issue of diversification and proper management, and unless you're looking at a depression scenario, a properly diversified and managed scenario really doesn't present those risks to the FSLIC. And I think——

Mr. PARRIS. Would you characterize that kind of relative numbers as a barometer——

Mr. PRATT. Well, I think it's very interesting. You know, to be very frank, it would be very interesting to do a case study of Columbia Savings & Loan, which has been the leader historically in the investment in noninvestment grade securities. And while I haven't made a study of that institution, my belief is it has probably done it on a very professional basis and has had relatively good results from doing so.

It's very interesting to see a firm nearby, the Beverly Hills, which seems to have had extremely bad results. I haven't looked into that. I think a case study of those two approaches may be very interesting.

Another issue is—and in many ways, we hate to say this, of course—but the real king of this business has been Drexel. And a case study of Drexel has got to be a real investigation of the high-yield securities market. They've clearly done the best job in developing that business.

We wish, in many instances, it weren't so.

Mr. PARRIS. There's the second commercial for you, Mr. Andersen. [Laughter.]

Mr. PRATT. If there's a risk there, it may be that they have done such a good job, that they're limited market makers in some issues. But I really think that it would be very instructive to focus in very specifically on who's done a good job, who's done a bad job, and what we can learn from that.

Mr. PARRIS. It would only be fair, and then I will get to you, Dr. Altman, it would only be fair to permit you to respond to that, Mr. Andersen.

Mr. ANDERSEN. Thank you very much. I'd like to point out that Columbia probably has among the highest earnings in the entire S&L industry today, if not the highest. They have $1 billion plus in high-yield bonds. Beverly Hills had $20 million, to the best of our knowledge and recollection. When the examiner went through the Beverly Hills account, high-yield bonds were mentioned in passing. They were not a factor of any significance whatsoever. They were purchased from four brokerage firms. They were purchased without regard, to the best of our knowledge, to good underwriting

practices, to diversification of portfolio, all of the things that we have consistently advocated.

And, yes, we have done a good job in developing that market. And one of the reasons is because we have gone to great length to try and educate people for many years. And one of the basic, fundamental tenets, and it comes right out of the Bureau of Economic Research Report that was the fundamental premise on which we based this, that the one thing you must have is adequate diversification. You've got adequate diversification in this entire century. Your rates of return have been spectacularly in excess of that on high-grade investment. And it continues and it's even more so today.

Thank you.

Mr. PARRIS. Thank you. Doctor?

Dr. ALTMAN. I was just going to try to comment on the Columbia S&L. There was an interview with its president in a magazine called High Performance, July 1985. They list diversified portfolio. I have it in front of me if there's any interest. Apparently, they're in 13 different sectors, the largest of which is 12.3 percent in the oil and gas sector, which might be of some concern.

But I think if you look through their portfolio in terms of percentages, and I think the quote of over $1 billion is correct, you'll see what would probably, from a classical securities analyst's standpoint, be a very diversified portfolio. I don't know how it would really bear out in terms of the way these rates of return would vary given, for example, a $5 per barrel drop in the oil prices, which to me is a lot more of a pressing interest than you have one stock, one bond in a hotel, one bond in manufacturing, and so on down the line in industries.

To me, that's somewhat passe as a form of diversification, but it's an ad hoc approach.

I think you really have to look at what are the major shocks that can occur to the economy and then say how does the particular portfolios, how will they be impacted by that. And I'm talking about inflation, prices of oil, and trade policies, which, of course, is another important issue.

Mr. PARRIS. Let me make certain that the record indicates that I in no way intend to characterize the Columbia S&L in any jeopardy of any kind or unfortunate in their choice of investment opportunities, that sort of thing. I do not mean that.

I use them simply as an example of an institution which may apply to some of our concerns in this regard.

Let me just—and my time is expired. I must relinquish to my friend from Texas. But another question, and perhaps we have more questions here this morning than we have precise answers. But the question, it seems to me, is it necessarily evil, or is it not, in what is increasingly a deregulated environment that Federal insurance encourages the biggest and riskiest gambles to get the highest possible returns by some managers of some institutions?

Is that or is that not the kind of a climate that we want to enhance and promote in this Nation's delivery of financial services?

And it seems to me that that's basically why we're here.

Mr. PRATT. Could I just respond to that?

Mr. PARRIS. Very briefly, yes.

Mr. PRATT. It seems to me that we just have a very fundamental philosophical problem that at some point needs to be faced concerning what deposit insurance does, and if it makes private credit into federal credit.

For instance, you could establish a financial institution that held nothing but noninvestment grade securities and then issued deposits which became insured. And what you have done is transformed noninvestment grade securities into U.S. Government debt. And the same is true with real estate investments. It's true with single-family detached houses.

I really think we need to get to some fundamentals with the changing technology, which has really changed the world of insured financial institutions. We're operating with a 1930's system in the space age. I think we need to get back to some real philsophical reexaminations and determine what the role of Federal insurance is and does it, if left to itself, transform all private credit into Federal Government credit?

I think those issues have to be examined.

Mr. PARRIS. If nothing else, I think we've made a great case this morning for risk-related insurance.

And I yield back the balance of my time.

Chairman HUBBARD. Thank you. Now we ask Chairman Henry Gonzalez for questions.

Mr. GONZALEZ. Thank you very much, Mr. Chairman.

Ms. Williams, on page 10 of your statement, you say, "As you know, the current statutes of both the FSLIC and the Federal Deposit Insurance Corporation basically provide only for premiums set at a flat rate of one-twelfth of 1 percent of total domestic deposits. This insurance premium structure was designed to function in a regulatory climate where variation and magnitude of risk were not significant issues, and the Congress did not contemplate those issues when it created these insurance funds."

At that time, though, wasn't that rate not less than 3 percent? And at one point was it not set at 7 percent?

Ms. WILLIAMS. Congressman Gonzalez, I believe that's correct, although I am not an expert on the history of the insurance rate structure.

Mr. GONZALEZ. I do know that at one time—I don't know if it was contemporaneous with the congressional action or the regulatory environment, but I think it was around 3 percent. And that had been reduced quite drastically from what had been the norm.

But I think that explains why, as you say, the Congress did not contemplate those issues at the time. Some of us were anticipating. Some of us did raise the issue. And, unfortunately, we couldn't get any attention focused. I appeared—it was quite difficult for me to go to the Rules Committee and be the only voice opposing my own chairman on what turned out to be the Garn-St Germain bill, because it was presented as a sort of a single issue; that is, save the S&L's.

The truth was that it was the most drastic wholesale revision of the 1935 basic banking law that we have had since 1935.

However, that's past.

I was just interested in knowing just what, if any, should be the congressional interest now in either, through persuading the regulatory board or legislation upgrading that rate.

I'd just like to say by way of a comment, Mr. Andersen, that your corporation's activities and all of the things that have arisen as a consequence of an unregulated, in my opinion, extortionate, unconscionable rate of interest environment—your success is predicated on a sustainment of that excessively high rate of interest.

All of those activities, money market and all, have a built-in dependence on maintaining that. But, like water, ultimately they seek their true level. And a tree can't grow to heaven.

So what I'm afraid of is when you do have the ultimate and unavoidable confrontation with a future shock in your limits on interest rates, I think we are on the threshold of seeing that worldwide.

I just want to say that it seems to me that we have drifted into this environment, all with good intentions and perhaps out of sheer necessity. But that until we address that, I think we're all kind of flailing around.

I don't know what under our system the Congress could really do at this point, or could have done, though I repeat, there were voices in this Congress that clearly, very coherently, anticipated, tried to warn, as far back as the credit crunch of 1966.

The handwriting was on the wall, I thought, and it just seems kind of pathetic that we would be now really flailing in the midst of some forces that we can't now control because we have such an interdependence that events outside the jurisdiction of our Nation impact and impinge on us in such a way that we can't control.

So I just wanted to make that observation because it's been very troubling to me, and I'm very troubled now and feel that it's a very high point of vulnerability.

Mr. ANDERSEN. May I comment, sir?

Mr. GONZALEZ. Certainly.

Mr. ANDERSEN. Congressman Gonzalez, I will assure you that there is probably no person in this room today that recognizes greater vulnerability to the interest rate shock to this Nation than the gentleman who is speaking to you right now. Nobody here is more concerned.

I, however, profoundly believe that the greater risk is in volatility of interest rates rather than extending the maturity and fixing the interest rates. I also believe that one of the things that has happened in the regulatory environment which has been an absolute blessing and an offset here is that we have speeded up our processes in the issuance of securities, so that the flexibility in the marketplace today to offer exchanges of debt for equity and the transmutation of one security into another are vastly in excess of what they have ever been.

The major reason that that has come about is because of some of the pioneering work that I believe our firm has done primarily in order to try and adjust to exactly those risks and those exposures.

It has happened over a decade and we've learned an awful lot. I don't think that the market in general understands the degree to which the flexibility is there. I think there is substantial offset to the problem if you have broad and liquid markets. I think the biggest vulnerability are the shocks that you receive from those things

which are outside of your control and outside of the control of managements when interest rates on floating rate debt spike and that debt is all held in the commercial banks and the companies get into trouble.

If you've got open, liquid markets where millions of investors can look at the markets and make decisions and dollars can flow in response, quick response, to economic changes, that is the only salvation that I see.

But I absolutely share your concern and I applaud you for your efforts, sir.

Mr. GONZALEZ. Thank you very much and let me say that I pray daily that the financial guardian angel will hover over you and all other American investment and mortgage bankers. [Laughter.]

I have nothing but the best good will and intention for you.

I yield back the balance of my time in favor of you, so that you can ask those questions, Mr. Chairman.

Chairman HUBBARD. Thank you very much, Congressman Gonzalez. Chris Andersen now knows that he not only has praise in this room, but also prayers. [Laughter.]

Which is no doubt encouraging to him as he visits us. I'm going to yield to our ranking minority Member and then come back for my questions.

Mr. PARRIS. Thank you, Mr. Chairman. I just have one observation to make, and that is that Mr. Andersen has not only had the commercial support this morning; he's now been divinely guided by Mr. Gonzalez. [Laughter.]

That's been a pretty good day for you, Mr. Andersen. [Laughter.]

Mr. PRATT. Mr. Parris, the prayers cancel out. [Laughter.]

Mr. PARRIS. I just wanted to follow up on what you said because I think it was totally pertinent and appropriate, Mr. Andersen. I have previously put in the Congressional Record an editorial, I suppose it would be correctly labeled, and I won't burden you with all of it, but I commend it to you. It follows very much what Mr. Pratt alluded to a moment ago in terms of a 1930's process in which we're attempting to apply some involvement on the part of the Federal Government, or whatever. It's very much like vacuum tubes in this day of the chip.

This statement has to do with a thing called the process of creative destruction, which I'm sure Dr. Altman has heard before.

The point of all this is that there is change in any capitalist structure. Certainly there is one in this one in terms of economic exchange. It is never stationary.

The point that I wanted to just make is that greed is disciplined by the marketplace in this or any other economic venture. This statement says, in part,

> Raiders are going to pick companies on which they think they can make money. Junk bond dealers and buyers will back deals on which they think they can make money. The arbitragers will buy only if they think they can make money on a successful deal. Shareholders will sell only if the stock price goes up. That's what this is all about.

And that may very well be, those immutable laws of economic persistence and survival, may, in fact, in this whole issue be preferential to some heavyhanded insertion of the Federal Government and this committee and this subcommittee into this whole picture.

That question has not yet been determined by, I suppose, any of us, including this Member. But I submit it as a profoundly interesting question that all of us are going to have to address one of these days soon.

Chairman HUBBARD. Thank you very much. We should be through in less than 10 minutes. At this point, we're very fortunate to have met this long without an interruption of a rollcall on the House floor.

Dr. Altman, I didn't get to ask you any questions. I want to commend you upon your in-depth analyses of your studies into this area of our concern. However, your assessments of the situation and indeed, your recommendations are all derived from experiences of the time period since 1978.

Are your findings and recommendations made today with the underlying assumption that the economy will remain on the same average upward trend as it has since 1978? In my area of the United States, western Kentucky, we hope that we don't have an economic downturn. But with the farm credit crisis, high sulfur coal in my area having problems with the environmentalists, et cetera, we fear an economic downturn in our area.

If that be true in other areas of the United States, would you care to speculate as to what might be the state of affairs with high-yield bond issuers should we experience an economic downturn?

In short, how would these companies fare in servicing their high-interest obligations if we had a downturn in the economy?

Dr. ALTMAN. I believe it's fair to say that the economy has not had a continuous upturn since 1978. We did go through, in my opinion, probably the most serious recession since the Depression in the 1980 to 1982 period. And that is reflected by the default rate on high-yield bond securities in 1982, which, depending on how you calculate it, was certainly over 3 percent and maybe over 4 percent, and we observed that happening in the past on two other occasions as well.

I might say parenthetically that the bankruptcy rate in the United States, despite our expansion since 1982, is still at record postwar levels. So I can certainly sympathize with the people in Kentucky and other States in the country that are not experiencing the overall upsurge in the economy that the overall macroeconomic numbers we're getting out of all sorts of statistics and locations like Washington, seem to imply that we've been in an upward mode for a long period of time.

I think this country has real pockets of economic problems. I'm not a macroeconomic forecaster, but I've read enough to say that a lot of people are forecasting a recession in 1986 or 1987 and, no doubt, that will impact high-yield bonds just like it's going to impact those institutions that borrow from banks and savings and loans in the more traditional way of borrowing that it has been in the past.

So I think we certainly can expect that the default rate will increase over the next 5 or 6 years from what it is today, which is probably—last year it was just under 1 percent. The year before, just over 1 percent.

I don't have any doubt in my mind that the default rate will probably jump several percentage points over the next half dozen years in a particular year or two.

So I think, yes, there is a risk that the default rate will rise, and that's why you do need that diversification aspect. It's not going to rise across the entire economy on a broad basis, I don't think. At the same time, if you're in one or two issues and you've got $100 million worth of that debt and that could bring you under the capital requirements, that's a very serious situation.

So, I didn't mean to imply in my comments, nor in my data, that we've had an easy time in the past and that means that we're going to have an easy time in the future. If you read some of the things coming out of Wall Street, about years ago in this area, they cited the default rate on corporate debt as being under one-tenth of 1 percent. There was no risk in investing in corporate debt.

I was one of the vocal critics at that time looking at the past and saying things about what will happen in the future. I think the economy is vulnerable to shocks and we'll have them again. It's the normal type of business cycles that we go through.

It's going to hit, certainly, some areas harder than others and certainly, the default rate on high-yield bonds will be higher than the default rate on investment-grade bonds. So will the yields. That's sure to happen, and that's why I think your concerns on diversification and my comments and others on some sort of prudence with respect to the choice of securities is totally appropriate.

Chairman HUBBARD. The success of your testing is interesting; in fact, remarkable. Can the Zeta model be used feasibly to help reduce defaults experienced among high-yield bond issuers?

Dr. ALTMAN. I'm convinced that whether it's Zeta or a sophisticated credit-scoring system which is not only common to Zeta but in other places, can significantly reduce the default rate of any portfolio.

That doesn't mean, however, Mr. Chairman, that you won't incur some losses in investment in a security if you get out 6 months before it goes under because the history shows that the price deterioration doesn't come just at the news of default. It comes over a period of time.

But I do think that you could all but eliminate defaults—I shouldn't say that. That's a little strong.

We have experienced in two cases, using a conservative Zeta approach, in the *Storage Technology* case and certainly *Johns Manville* and in *Revere Copper & Brass,* that the model would not have been successful.

Those are the only ones that I'm familiar with in the many issues that have defaulted in the last 6 or 7 years.

Chairman HUBBARD. Thank you very much, Dr. Altman. Before we forget it, please extend our greetings to Dr. John Brademas, your president and our former colleague from Indiana.

One last question for our other three witnesses. To Dick Pratt—If financial institutions were suddenly told that they unequivocally could no longer invest in high-yield bonds, how much of an effect would that have on the high-yield bond market? Merrill Lynch deals with institutional investors directly in the marketplace.

Mr. PRATT. Well, I think it depends on the nature of that prohibition. You've got $4 billion, plus another $1 billion held in subsidiaries. That's a significant portion and would certainly, if it had to be liquidated instantaneously, cause very major shocks.

In a macrosense, I don't think that a phaseout over an extended period of time would have a major impact on the high-yield markets and they would readjust as new investors from other sectors were found. I think high-yield issuance would clearly survive the absence of the thrift industry.

That's not to say that I think it's desirable, obviously.

Chairman HUBBARD. To Chris Andersen, has there been a decline in new issues of high-yield bonds?

Mr. ANDERSEN. Has there been——

Chairman HUBBARD. Has there been a decline in new issues of high-yield bonds?

Mr. ANDERSEN. Has there been any time during the past 10 years when you've had a falloff?

Chairman HUBBARD. In recent months?

Mr. ANDERSEN. No; it's been fairly consistently upward. What we've found basically is that the issuers of high-yield bonds, the vast majority of them are companies which are overly committed, that is, they borrowed heavily in the commercial banking system. And so the demand for longer term fixed-rate debt in this sector has consistently outstripped the market's ability to absorb it over any period of time longer than a couple months.

Chairman HUBBARD. And to Julie Williams—on page 10 of Chris Andersen's testimony, we read that nearly $800 million in capital has been injected into the thrift industry.

Does the Bank Board have concerns about thrifts issuing their own high-yield bonds?

Ms. WILLIAMS. The Bank Board does have concerns. Generally, you would look at those in two respects. One is the issuance of debt and the other would be the question of issuance of what is known as subordinated debt, which is subordinate to the claims of certain creditors in the event of liquidation, and basically, gives the FSLIC a preference.

We do scrutinize very carefully the issuance of subordinated debt by insured institutions because of the net worth treatment that will be accorded it. The Bank Board recently looked at the issuance of debt securities and subordinated debt by insured institutions and made some revisions in its regulations this past spring in order to more realistically treat in its regulations the net worth that for regulatory purposes, can be derived from subordinated debt.

Mr. PRATT. It's interesting, if I can just comment on that, it's interesting to note that a plan has been suggested which would encourage the issuance of more junk bonds by commercial banks. I believe Chairman Isaac has suggested the raising of capital requirements, a portion of which would be supplied by the issue of subordinated debentures. In the bank and savings and loan world, the issuance of most debt would be junk debt.

I would guess in the savings and loan business, issuance of subordinated debentures, not more than 5 or 6 out of the 3,500 institutions in the United States could issue anything but the noninvestment grade security as a subordinated issue.

Chairman HUBBARD. Any further comment or questions by either of my colleagues?

Mr. GONZALEZ. I would like the record to state that I accept the observation and recommendation of most of the witnesses that referred to that. And that is, I think a congressional attempt to impose a moratorium or prohibition on this would be contrary to the best interests of all concerned.

At one time many years ago, I was chief juvenile probation officer for Bexar County. I studied for a while some of the records and came to the conclusion that in the case of some of the child offenders that were brought to our attention, if not most of them, the least we did to interfere with the normal recovery to a nondeviational pattern, the better off the child was. And I think in this case, too, I think the phrase Mr. Pratt used that a substitution of a regulatory or a legislative judgment for management in this case would be unwise.

So at this point, I would tend to be contrary-minded to the imposition of a moratorium or a prohibition.

I do think that that ought to go on the record.

Chairman HUBBARD. We thank you four excellent witnesses who have given of your time and testimony this morning and this afternoon for the benefit of our subcommittee and our full Banking Committee and, indeed, the 99th Congress.

Special thanks to our staff director, Mary Martha Fortney, to our majority counsel, Greg Carter, to our minority counsel, Ed Carroll, and to our staff members, Harold Garrison, Eileen Gunzelman, and Pam Satterwhite, and to Gary Howard, the reporter. Also thank you to those of you who have sat through our 2 hour and 13 minute hearing today.

If there's nothing else, then we declare our subcommittee hearing adjourned.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

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